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# International Trade and Business

## Law Review

Volume XIII, 2010

The *International Trade and Business Law Review* publishes leading articles, comments and case notes as well as book reviews dealing with international trade and business law, arbitration law, foreign law and comparative law. It provides the legal and business communities with information, knowledge and understanding of recent developments in international trade, business and international commercial arbitration. The *Review* contributes in a scholarly way to the discussion of these developments while being informative and having practical relevance to business people and lawyers. From time to time, the *Review* also devotes a section to the Willem C. Vis International Commercial Arbitration Moot and publishes the memoranda prepared by a team coached by Professor Gabriël A. Moens.

The *Review* is edited at the Murdoch University School of Law in Perth, Australia. Editor-in-Chief is Gabriël A. Moens, Dean and Professor of Law, Murdoch Law School. It is an internationally refereed journal. The *Review* is supervised by an international board of editors that consists of leading international trade law practitioners and academics from the European Union, the United States, Asia and Australia. The Student Editors for Volume XIII are Michael Browne, Kara Churchward, Dean Tingey and Claire Vinten from the Murdoch Law School.

# **International Trade and Business Law Review**

Volume XIII, 2010

## *Editor*

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Murdoch University, Australia

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Volume XIII, 2010

**Gabriël A. Moens**

Murdoch University, Perth

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# Articles



# AN INTRODUCTION TO INVESTOR-STATE ARBITRATIONS

**Gordon Smith\***

## **Abstract**

This article introduces the reader to the intricacies of international investment treaties and investor-state arbitration. Bilateral Investment Treaties (BITs) are the most common type of international investment treaty whereby contracting states agree to promote and protect investments made in their territory by investors of the other contracting state. They generally provide for disputes arising under the treaty to be resolved through investor-state arbitration by *ad hoc* arbitration under the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules or under the Convention on Settlement of Investment Disputes between States and Nationals of Other States 1965 (the ICSID Convention).

This article describes the key provisions typically contained in BITs, and discusses common issues that arise during arbitration of claims under these treaties. Parties to investor-state arbitrations frequently object to claims on procedural and substantive grounds. It is also common for tribunals to arbitrate disputes over the interpretation of dispute resolution provisions.

All BITs typically cover the same grounds, but the specific wording of individual BITs can vary. As a result, the level of protection provided by individual BITs varies. ‘Forum shopping’ is common because international investors frequently find that an investment in a given host state is covered by several international investment treaties.

## **1. Introduction**

Investment treaties are agreements between two or more states by which each contracting state agrees to promote and protect investments made in its territory by investors of the other contracting state or states. The majority of treaties are BITs.

The first BIT was signed in 1959 by Germany and Pakistan. However, it was not until the 1980s that countries started to increasingly negotiate and enter into BITs, in parallel with the substantial growth of international investment, which has required a more flexible and precise international law than previously provided under customary international law. There are now well over 2500 BITs globally,<sup>1</sup> and such treaties therefore play an increasingly significant role in global trade and investment protection.

The underlying rationale for BITs on the part of the capital exporting country is that they provide foreign investors with a degree of protection for capital invested, and the opportunity to acquire market share in the relevant domestic economy. From the developing country’s perspective, BITs are intended to increase the inflow of foreign investment, and thereby contribute to the country’s economic development.

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\* Special Counsel, Allens Arthur Robinson, FCIArb, FSIArb, FIEAust, CARb, CPEng.

<sup>1</sup> ‘Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking’, 2007, UNCTAD.

Foreign investors generally have the right to bring disputes with the host state to international arbitration under BITs for breach of the protection provisions of BITs in what is known as the ‘investor-state arbitration process’. Such arbitrations involve the state in its sovereign capacity. To date there have been approximately 320 known investor-state disputes, with approximately 65% of these filed with the International Centre for Settlement of Investment Disputes (ICSID) in Washington (the Centre) under the ICSID Convention. The remainder are conducted under the common international commercial arbitration rules, principally under the UNCITRAL ad hoc arbitration rules, but with a small number under institutional rules.<sup>2</sup>

It was only from around 1995 that investor-state cases started to increase, from a maximum of three or four new cases per year, with the average number of new investor-state arbitrations now more than 50 per year. Of the 109 concluded cases, approximately half were decided in favour of the investor, and half in favour of the state.

At least 78 governments, with approximately 48 in the developing world, have faced investment treaty arbitrations, with most claims initiated by investors from developed countries. Argentina has the most number of claims filed against it, with 49 listed ICSID arbitrations, 15 of which have been concluded. Most of these arbitrations have arisen as a result of the financial crisis in Argentina during 2001/02, and the subsequent regulatory measures taken by the Argentine government, including freezing foreign assets and prices. The claimants include some of the major energy and infrastructure companies, such as France Telecom, BP, Hochtief, Suez, El Paso Energy, and Siemens.

Australia has entered into 24 BITs, principally with developing countries in Asia, South America and Eastern Europe. Australia has never been the subject of a claim under a BIT. A total of eight Australians are listed on the ICSID panel of arbitrators, some of which have been appointed to ICSID Arbitral Tribunals.<sup>3</sup> However, given the continued growth of investment by Australian companies internationally, and the current economic conditions, it seems likely that Australian companies will increasingly consider the appropriate investment structure to take advantage of a relevant BIT, and consider the terms of BITs for remedies against states.

### **i. Overview of Key BIT Provisions**

The provisions of BITs typically fall into one of three broad categories: jurisdictional provisions; substantive protection provisions; and dispute resolution provisions:

- (a) jurisdictional:
  - (i) the requirement for nationality; and
  - (ii) the scope of investments covered;

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<sup>2</sup> ‘Latest Developments in Investor-State Dispute Settlement’, IIA Monitor No 1, 2009, United Nations.

<sup>3</sup> Dr Gavan Griffith QC (seven appointments), Professor Michael Pryles (three appointments), and Andrew Rogers QC (three appointments).

- (b) substantive protection:
  - (i) protection from expropriation or nationalisation;
  - (ii) fair and equitable treatment;
  - (iii) full protection and security; and
  - (iv) observance of obligations (umbrella clauses);
- (c) dispute resolution.

Whilst BITs typically cover these three broad categories of provisions, this does not mean that the provisions are identical, or contain the same degree of protection. On the contrary, examination of individual BITs reveal a wide divergence in the specific language adopted, and the degree of protection provided.

BITs usually provide for disputes between investors and states to be resolved by international arbitration at the Centre under the ICSID Convention. Unlike normal international commercial arbitrations, which are confidential in nature, international arbitrations conducted under the auspices of the Centre are publicly notified, and the Centre publishes investment treaty arbitral awards. Although these awards are technically not binding on subsequent arbitral tribunals deciding similar issues under BITs, and in some areas of the law are contradictory, they provide a useful body of arbitral jurisprudence for parties involved in BIT claims.

## **2. Jurisdictional Issues**

### **i. Introduction**

State parties to investor-state arbitrations will almost inevitably object to an investor's claim on various jurisdictional grounds, and these issues are usually decided by arbitral tribunals separately from an investor's substantive claim. As an example, during 2008 there were at least 16 decisions where arbitral tribunals were required to decide an objection to their jurisdiction, and in four cases the arbitral tribunal accepted the objection and dismissed the entire claim. Such challenges often include whether an investor qualifies as a 'national', or whether the particular investment falls within the definition of 'investment', under the relevant BIT.

### **ii. The Definition of 'National' or 'Investor'**

The term 'treaty shopping' refers to the process of international investors assessing a number of different investment treaties which may apply to their investment in a given host state, and structuring their investment in a way to maximise the degree of protection provided under an applicable treaty. Clearly, whether an investor properly falls within the definition of a 'national' or 'investor' within a relevant treaty is a fundamental issue for an investor in assessing suitability of BITs.

All BITs contain definitions of the term ‘national’ or ‘investor’ for the purpose of making it clear which entities are covered by the protection offered by a BIT. These provisions broadly fall into two categories:

- a) incorporation in the host state, without other restrictions; or
- b) less commonly, incorporation in the host state, together with other restrictions usually relating to control of the entity, such as a requirement that a company’s place of ‘effective management’ be situated in the country of incorporation, or that a company is ‘actually doing business’ in the country of incorporation.<sup>4</sup>

The purpose of specifying in BITs additional restrictions on nationality other than incorporation in the host state is to prevent ‘treaty shopping’.

Shell companies controlled by their overseas owners have generally been entitled to claim for breaches of a host state’s BIT obligations. For example, in *Saluka v Czech Republic*,<sup>5</sup> the arbitration arose out of the reorganisation and privatisation of the Czech banking system. Saluka Investments BV, a Netherlands company, had acquired shares of the Czech state-owned bank, IPB. The bank was forced into administration by the Czech Government following a string of runs on the bank during 2000. IPB was then sold for the nominal price of one crown. CSOB, another bank, acquired IPB and was given financial aid by the state.

Saluka commenced arbitration under the UNCITRAL Rules for its claim for compensation of approximately US\$1.4 billion, claiming violation of Art 5 (deprivation of investment) and Art 3 (fair and equitable treatment) of the BIT between the Netherlands and the Czech Republic. Saluka was successful in its claim for breach of Art 3.

The Czech Republic argued that the real investor was not Saluka but an English registered company, and asserted that Saluka was merely a shell company with no real economic interest in IPB shares, and therefore failed to meet the definition of an investor under the BIT. The tribunal rejected this argument on the basis of the wording of the BIT, which defined investors as ‘legal persons constituted under the law of one of the Contracting Parties’, without any further restriction.

The line of reasoning in *Saluka v Czech Republic* was also recently followed in *The Rompetrol Group NV v Romania*<sup>6</sup> where the arbitral tribunal rejected Romania’s argument that the Netherlands’ claimant company was controlled or owned by a Romanian national. The tribunal concluded that:

... neither corporate control, effective seat, nor origin of capital has any part to play in the ascertainment of nationality under The Netherlands-Romania BIT, and that the Claimant qualifies as an investor entitled to invoke the jurisdiction of this Tribunal by virtue of Article 1(b)(ii) of the BIT.<sup>7</sup>

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<sup>4</sup> Other formulations include the power to appoint the majority of the board of directors or otherwise to legally direct the operations of the investment.

<sup>5</sup> *Saluka v Czech Republic*, Ad hoc, UNCITRAL Arbitration, Partial Award, 17 March 2006.

<sup>6</sup> ICSID Case No ARB/06/3, Decision on Jurisdiction, 18 April 2008.

<sup>7</sup> *Ibid* at [110].

Whilst the jurisprudence arising out of BIT claims and ICSID arbitrations indicate that, absent a particular limitation in the relevant BIT, it is permissible to locate an organisation in a jurisdiction which provides a beneficial regulatory and legal environment, including the availability of a BIT, tribunals are likely to give effect to any terms of a BIT which indicates an intention to prevent ‘treaty shopping’.

Such restrictions can take a number of forms. For example, a requirement in a treaty that a company’s place of ‘effective management’ be situated in the country of incorporation was considered in *Yaung Chi Oo Trading Pte Ltd v Myanmar*.<sup>8</sup> The claimant in that case argued that companies incorporated in Singapore should be deemed to be effectively managed in Singapore for the purpose of the relevant treaty (1987 ASEAN Agreement). The tribunal rejected this argument, noting that the treaty required both local incorporation and effective management, and that there was no justification for ignoring either requirement. The tribunal expressly referred to the restriction on nationality as being for the purpose of preventing ‘treaty shopping’, as follows:

... the requirement of effective management of the investing company in the place of incorporation was primarily included in the 1987 ASEAN Agreement to avoid what has been referred to as ‘protection shopping’; i.e, the adoption of a local corporate form without any real economic connection in order to bring a foreign entity or investment within the scope of treaty protection.<sup>9</sup>

The tribunal in that case found that the Singapore company was in fact ‘effectively managed’ from Singapore. The tribunal was influenced in its decision by the company’s continuous procurement of goods and materials from Singapore, that there existed a company address in Singapore, and that there was one continuously resident director of the company in Singapore.

Even in the absence of restrictive requirements in the definition of ‘national’, it was suggested in *Tokios Tokeles v Ukraine*<sup>10</sup> and *ADC Affiliate Ltd v Hungary*<sup>11</sup> that a tribunal may look at the nationality of shareholders when considering the nationality of an investor-company where there has been an ‘abuse of legal personality’ (*Tokios Tokeles v Ukraine*) or where ‘the real beneficiary of the business misuse[s] corporate formalities in order to disguise its true identify and therefore to avoid liability’ (*ADC Affiliate Ltd v Hungary*). In *Tokios Tokeles v Ukraine*, the tribunal considered that there had not been any abuse of legal personality, as the claimant had not created the company for the purpose of gaining access to ICSID arbitration under the BIT, and that the company had been established prior to the BIT coming into force. It has been suggested that this decision casts doubt on the propriety of a claimant reorganising itself or its investment structure after a dispute arises in order to sue the host state under a given treaty.<sup>12</sup>

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<sup>8</sup> ILR, vol 124, p 43, Final Award, 31 March 2003.

<sup>9</sup> *Ibid* at [52].

<sup>10</sup> ICSID Case No ARB/02/18, Decision on Jurisdiction, 29 April 2004.

<sup>11</sup> ICSID Case No ARB/03/16, 2 October 2006.

<sup>12</sup> J Savage, ‘Investment Treaty Arbitration and Asia: Review of Developments in 2005 and 2006’ (2007) 3(1) *Asian International Arbitration Journal* 1, 19 (n 67).

In circumstances where the relevant BIT contains some restrictions on nationality beyond simply incorporation, investor companies with substantial investments in the host state will typically try to arrange their management and control to comply as far as possible with criteria such as ‘effective management’ and ‘actually doing business’ at the place of incorporation in order to maximise the success of a defence to a jurisdictional challenge.

### iii. Investments Covered under BITs

The definition of ‘investment’ is typically drafted widely in BITs using phrases such as ‘means every kind of asset owned or controlled and invested by investors of one Party’.<sup>13</sup> Where specific examples of investments are specified these are drafted as being without restriction, reflecting the commercial reality that international investments and investment structures take many forms and have varying degrees of complexity.

One issue that has arisen in the cases is the extent to which a shareholder in a company has standing to bring an independent claim under the relevant BIT. Generally, the jurisprudence related to investor-state disputes has been in favour of shareholders being entitled to claim under a BIT with respect to the portion of shares they own or control.<sup>14</sup> Shareholders of a locally incorporated company are recognised as having independent standing in relation to the actions of the host state that have affected the locally incorporated company. The participation in the locally affected company is the requisite investment for the purpose of the BIT, and the foreign shareholder in the company can pursue the claim in its own name for adverse action by the host state against the company that affects its value and profitability.

Minority shareholders may rely on their shareholding as an ‘investment’ for the purposes of the relevant BIT and claim for loss of shareholder value in this way.<sup>15</sup> The protection of shareholders has also been extended to those with indirect shareholdings, through an intermediate company, in the affected company.<sup>16</sup> However, it has been suggested that, where the claimant is both a minority and an indirect shareholder in the affected company, there may be a cut-off point in the protection afforded by a BIT.

The relevant case is *Enron v Argentina*,<sup>17</sup> where the claimant had an indirect shareholding of 35.263% in the affected Argentinean company, TGS, as follows:

- a) the claimant, through two wholly-owned companies (EPCA and EACH), owned 50% of the shares of an Argentine company (CIESA) that controlled TGS by owning 55.3% of its shares;

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<sup>13</sup> Canada has recently adopted a ‘closed list’ definition of ‘investment’ by specifying an exhaustive list of what constitutes an investment for the purpose of the treaty.

<sup>14</sup> ‘Definition of Investor and Investment in International Investment Agreements’, Working Party of the Investment Committee, OECD Directorate for Financial and Enterprise Affairs, 2007, p 123.

<sup>15</sup> *Lanco International Inc v Argentina*, ICSID Case No ARB/97/6, Decision on Jurisdiction, 8 December 1998; *CMS Gas Transmission Co v Argentina*, ICSID Case No ARB/01/8, Decision on Jurisdiction, 17 July 2003.

<sup>16</sup> *Siemens AG v Argentina*, ICSID Case No ARB/02/8, Decision on Jurisdiction, 3 August 2004; (2005) 44 *ILM* 138; *Waste Management Inc v Mexico*, ICSID Case No ARB(AF)/00/3, Final Award, 30 April 2004. Some BITs expressly provide for indirect investments by the terms of the definition of ‘investment’; for example, ‘every kind of investment, owned or controlled directly or indirectly ...’.

<sup>17</sup> *Enron Corp and Ponderosa Assets LP v Argentina*, ICSID Case No ARB/01/3, Decision on Jurisdiction, 14 January 2004.

- b) the claimant, through EPCA, EACH and another corporation controlled by it (ECIL), also owned 75.93% of another Argentinean company that owned 10% of the shares of TGS; and
- c) the claimant had acquired an additional 0.02% of TGS through EPCA.

The tribunal was concerned about allowing claims by claimants with minority indirect shareholdings in affected corporations, especially where several intermediate companies are involved. The tribunal made the following observations on the requirement for a cut-off point in the protection afforded by the relevant BIT:

... the Claimants made their investment in various companies participating in CIESA and only marginally in TGS. That is, they invested in a string of locally incorporated companies that in turn made the investment in TGS. The Argentine Republic has rightly raised a concern about the fact that if minority shareholders can claim independently from the affected corporation, this could trigger an endless chain of claims, as any shareholder making an investment in a company that makes an investment in another company, and so on, could invoke a direct right of action for measures affecting a corporation at the end of the chain ...

The Tribunal notes that while investors can claim in their own right under the provisions of the treaty, there is indeed a need to establish a cut-off point beyond which claims would not be permissible as they would have only a remote connection to the affected company. As this is in essence a question of admissibility of claims, the answer lies in establishing the extent of the consent to arbitration of the host State. If consent has been given in respect of an investor and an investment, it can be reasonably concluded that the claims brought by such investor are admissible under the treaty. If the consent cannot be considered as extending to another investor or investment, these other claims should then be considered inadmissible as being only remotely connected with the affected company and the scope of the legal system protecting that investment.<sup>18</sup>

The tribunal in that case found that the claimant did have standing in its capacity as protected investors because the claimant had been specifically invited by the Argentinean Government to participate in the investment connected to the privatisation of TGS and was thus included within the consent to arbitration given by Argentina. Further, the claimant had certain decision-making powers in the management of TGS. The tribunal concluded on this point that:

The Claimants cannot be considered to be only remotely connected to the legal arrangements governing the privatization, they are beyond any doubt the owners of the investment made and their rights are protected under the Treaty as clearly established treaty-rights and not merely contractual rights related to some intermediary.<sup>19</sup>

The tribunal's view as to the need for a cut-off point for an indirect minority shareholding has been criticised as lacking legal foundation.<sup>20</sup> In light of the way in which cross-border investments are often structured through several intermediate companies, the ability of

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<sup>18</sup> *Ibid* at [50]–[52].

<sup>19</sup> *Ibid* at [56].

<sup>20</sup> C H Schreuer, 'Shareholder Protection in International Investment Law' (2005) 2(3) *Transnational Dispute Management* 1, 13.

minority indirect shareholders to claim against host states raises the potential for investors to take advantage of one or more treaties by intermediate companies submitting claims against the host state, giving rise to a further aspect of ‘treaty shopping’.

#### iv. The Definition of ‘Investment’ under Article 25(1) of the ICSID Convention

In order for an investor to qualify for disputes under BITs to be settled by international arbitration under the auspices of the Centre, the investment must be covered not only by the terms of the relevant BIT (as discussed above) but also by arguably the more restrictive definition of ‘investment’ under Art 25(1) of the ICSID Convention, which provides that:

... the jurisdiction of the Centre shall extend to any dispute arising directly out of an investment between a Contracting State ... and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre.

Whether there has been an ‘investment’ for the purposes of Art 25(1) is a separate question as to whether the case falls within the scope of consent given by the host state in light of the definition of ‘investment’ in the relevant BIT.<sup>21</sup> In *Joy Mining Machinery Ltd v Egypt*,<sup>22</sup> an ICSID tribunal emphasised ‘that there is a limit to the freedom with which the parties may define an investment if they wish to engage the jurisdiction of ICSID Tribunals’.

The ICSID Convention does not contain a definition of ‘investment’. However, there are several ICSID cases where tribunals have considered the requirements for satisfying Art 25(1). In *Fedax NV v Venezuela*,<sup>23</sup> the tribunal set out five basic features of an investment required in order to satisfy Art 25(1), and these criteria have generally been consistently applied by subsequent ICSID tribunals considering similar issues:

- a) the project should have a certain duration;
- b) there should be a regularity of profit and return;
- c) there is an element of risk for both sides;
- d) the commitment involved should be substantial; and
- e) the operation should be significant for the host state’s economic development.

In *Fedax NV v Venezuela* itself, Fedax was claiming under the Netherlands-Venezuela BIT, and was the beneficiary of a debt instrument issued by Venezuela. Fedax had not come into possession of the promissory notes as a result of any relationship with Venezuela, or any direct investment made in its territory. Venezuela argued that Fedax’s holding of promissory notes did not qualify as an investment under Art 25(1) because Fedax had not made a direct foreign investment involving a long-term transfer of financial resources. The tribunal rejected this argument, applying the above criteria, noting that there was a significant relationship between the transaction and the host state’s development.

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<sup>21</sup> See *CSOB v Slovakia*, Decision on Jurisdiction, 24 May 1999 at p 68; *Malaysian Historical Salvors v Malaysia*, Decision on Jurisdiction, 17 May 2007.

<sup>22</sup> ICSID Case No ARB/03/11, Decision on Jurisdiction, 6 August 2004.

<sup>23</sup> ICSID Case No ARB/96/3, Award, 9 March 1998.

Tribunals in some cases applying these criteria have noted that the criteria are often interdependent, and therefore should be assessed globally, rather than independently.<sup>24</sup> For example, the tribunal in *LESI SpA v Algeria*<sup>25</sup> doubted the necessity of specifically establishing the criteria of contribution to the economic development of the host state, and said it was implicitly covered by the preceding criteria.

An ICSID tribunal is likely to consider the entire investment operation for the purpose of determining whether there is an investment under the terms of Art 25(1). In *Ceskoslovenska Obchodni Banka v Slovakia*,<sup>26</sup> the tribunal said:

An investment is frequently a rather complex operation, composed of various interrelated transactions, each element of which, standing alone, might not in all cases qualify as an investment. Hence, a dispute that is brought before the Centre must be deemed to arise directly out of an investment even when it is based on a transaction which, standing alone, would not qualify as an investment under the Convention, provided that the particular transaction forms an integral part of an overall operation that qualifies as an investment.

As an example of the developing nature of ICSID decisions, an ICSID committee in *Malaysian Historical Salvors v The Government of Malaysia*<sup>27</sup> has recently come to a different conclusion on whether a foreign investment must contribute to the economic development of the host state as a jurisdictional issue in order to fall within the ambit of the ICSID Convention.

Malaysian Historical Salvors (MHS) was a marine salvage company owned by a British national, which had retrieved thousands of pieces of Chinese porcelain from the Straits of Malacca in the 1990s. In the contract with Malaysia, the company was to receive a portion of the proceeds from the sale of the treasure, but MHS maintained that it received a smaller proportion of the profits than was promised under the contract. MHS unsuccessfully sought to recover damages through the Malaysian courts, and then commenced proceedings at the Centre under the Malaysian-United Kingdom Bilateral Investment Treaty.

The sole arbitrator, in his award on jurisdiction, concluded that MHS' investment in a marine salvage operation had not made a significant contribution to the Malaysian economy, one of the five basic features referred to above for the purpose of Art 25(1), and held therefore that he did not have jurisdiction to decide the claim. MHS appealed the award under Art 52(1) of the ICSID Convention.

The majority of the Annulment Committee annulled the award of the sole arbitrator on the ground that he had manifestly exceeded his powers as an arbitrator by failing to exercise jurisdiction that was granted under the ICSID Convention and the Malaysia-United Kingdom Bilateral Investment Treaty.

The Annulment Committee noted that recourse to ICSID arbitration under the BIT was an investor's sole remedy, and that it would be incompatible with the states' joint intentions for

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<sup>24</sup> *Salini v Morocco*, ICSID Case No ARB/00/4, Decision on Jurisdiction, 23 July 2001.

<sup>25</sup> ICSID Case No ARB/05/3, Decision on Jurisdiction, 12 July 2006 at [72].

<sup>26</sup> ICSID Case No ARB/97/4, Decision on Jurisdiction, 24 May 1999; 5 *ICSID Reports* 335 at [72].

<sup>27</sup> ICSID Case No ARB/05/10, 16 April 2009.

an investor to have an investment in Malaysia, within the terms of the definition of the BIT, to be rendered nugatory by a restrictive definition of a deliberately undefined term of the ICSID Convention. The majority considered therefore that the arbitrator was incorrect not to consider the definition of investment under the BIT itself.

The majority also concluded that the sole arbitrator was wrong to elevate the criteria of a significant contribution to the Malaysian economy as a jurisdictional issue, and wrongly interpreted the alleged condition so as to exclude small contributions and contributions of a cultural and historical value.

### 3. Substantive Protection Provisions

#### v. Protection from Expropriation or Nationalisation

Foreign investors' claims have traditionally been based upon expropriation or nationalisation by the host state in the classic situation where a state blatantly seizes the investor's assets. All BITs provide the investor with protection from a state's expropriation or nationalisation of its investments without adequate compensation, and in wider terms than the protection accorded by customary international law. Typically, such provisions are worded as follows:

A Party shall not nationalise, expropriate or subject to measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as 'expropriation') the investments of investors of the other Party unless the following conditions are complied with ...

BITs do not provide a definition of 'nationalise, expropriate or ... equivalent to nationalisation or expropriation ...'. As such, reference must be made to international investment tribunal decisions in determining the relevant criteria for evaluating the actions by a state party which may breach such provisions.

Clearly, direct expropriation or nationalisation in the sense of forcible seizure by a state party, by legislation or otherwise, of tangible or intangible property of an investor without compensation is a breach of such provisions, for which investors are entitled to compensation under the relevant terms of the BIT, usually expressed to be the 'market value' of the investment.

The phrase 'equivalent to nationalisation or expropriation' has been interpreted by international tribunals as being a reference to conduct which is substantially wider than simply direct acquisition of property by a state party, and is said to be a reference to 'creeping expropriation' or 'de facto expropriation' of the investment. In those circumstances, the host state's actions do not involve overtly acquiring the investment, but the acquiring occurs when governmental measures or conduct have 'effectively neutralised the benefit of property of the foreign owner'.<sup>28</sup> Ownership or enjoyment can be said to be 'neutralised' where a party is no longer in control of the investment, or where it cannot direct the day-to-day operations of the investment.<sup>29</sup>

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<sup>28</sup> *CME Czech Republic BV v Czech Republic*, Ad hoc, UNCITRAL Arbitration, Partial Award, 604, 13 September 2001.

<sup>29</sup> *Pope & Talbot Inc v Canada*, Ad hoc, UNCITRAL Arbitration, Interim Award, 100, 26 June 2000.

In establishing whether a state's measures constitute expropriation in the sense of being a measure 'equivalent' to expropriation, international arbitral tribunals balance two competing interests: the degree of the measure's interference with the right of ownership of the investor; and the power of the state to adopt its policies.

In evaluating the degree of the measure's interference, international arbitral tribunals analyse (1) the severity of the measure's economic impact upon the investment; that is, interference with the investor's reasonable expectations; and (2) the measure's duration.

With respect to the severity of the economic impact, the relevant measure or conduct must be substantial. In a number of cases, tribunals have denied compensation in circumstances where the state's measure has not affected all or almost all of the investment's economic value. It has been held that interference with the investor's ability to carry on its business is not satisfied where the investment continues to operate, even if profits are diminished.<sup>30</sup>

With respect to the duration of the state's measure, the measure must be permanent, as distinct from being of a temporary nature.

An example of the relatively strict approach adopted by international tribunals is the case of *LG&E Energy Corp v Argentina*.<sup>31</sup> In this case, following a financial crisis in Argentina during 1999/2000, LG&E Energy Corp was compelled to agree with Enargas, the Government of Argentina's public agency responsible for the provision of natural gas, to postpone certain tariff increases for gas supply it was entitled to under its underlying investment agreements. Following this postponement, the Government of Argentina passed Presidential Decrees under which it adopted a currency conversion scheme under which all existing obligations payable in United States dollars would be converted into pesos at the fixed one-to-one exchange rate, and which abolished clauses in the agreements requiring tariff adjustments in United States dollars. These measures had a substantial effect on LG&E Energy Corp's investments in that it substantially reduced its earnings.

In the subsequent ICSID arbitration, LG&E Energy Corp argued that the measures implemented by the Government of Argentina amounted to indirect appropriation of its investment. The tribunal held that although the Government of Argentina adopted severe measures that had an impact on the investor's investment, particularly the earnings expected by the investor, such measures did not deprive the investor of the right to enjoyment of its investment. The tribunal came to the view that the true interests at stake were the investment's asset base owned by LG&E Energy Corp, which had actually increased in value over the relevant period.

Conventionally, 'creeping expropriation' or 'de facto expropriation', requires some regulatory or legislative action on the part of the state in order for an investor to be successful in a treaty claim under the expropriation provisions of BITs.<sup>32</sup>

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<sup>30</sup> *Pope & Talbot Inc v Canada*, Ad hoc, UNCITRAL Arbitration, Interim Award, 100, 26 June 2000.

<sup>31</sup> ICSID Case No ARB/02/1, Interim Award, 3 October 2006.

<sup>32</sup> *Consortium RFCC v Kingdom of Morocco*, ICSID Case No ARB/00/6, 22 December 2003.

However, more recently, investors have claimed expropriation as a consequence of breaches by the state of the relevant terms of an underlying contract. Tribunals considering such claims draw a distinction between behaviour of a state as an ordinary contracting party having a difference of approach (in fact or in law) with the investor, and the state going beyond behaviour which an ordinary contracting party could adopt, which is a breach of treaty obligations (note that umbrella clauses give rise to different considerations, as discussed below).

In *Impregilo SpA v Pakistan*, discussed above in the context of Art 3(3) of the treaty, the tribunal held that it had jurisdiction to hear Impregilo's claims for breach of Art 2(2) (fair and equitable treatment) and Art 5 (expropriation) of the relevant treaty, which were based on alleged breaches by Pakistan of the underlying contract.

Similarly, in *SGS v Pakistan*,<sup>33</sup> the tribunal held that it had jurisdiction to hear SGS' treaty claims for breach of Art 4(2) (fair and equitable treatment) and Art 6(1) (expropriation or measures having the same effect) arising from SGS' allegations of Pakistan's breach of the underlying contract.

In contrast, in *SGS v Philippines*,<sup>34</sup> the tribunal declined to accept jurisdiction over SGS' claims under Art VI (expropriation) of the relevant treaty, which was based on alleged breaches by the Republic of the Philippines of the underlying contract, on the basis that there had been no legislative action by the Republic of the Philippines to extinguish the outstanding amount due under the contract. In this context, the tribunal stated:

Whatever debt the Philippines may owe to SGS still exists; whatever right to interest for late payment SGS had it still has. There has been no law or decree enacted by the Philippines attempting to expropriate or annul the debt, nor any action tantamount to an expropriation ... A mere refusal to pay a debt is not an expropriation of property, at least where remedies exist in respect of such a refusal.<sup>35</sup>

Tribunals also draw a distinction between indirect expropriation and legitimate regulatory measures. For example, the tribunal in *Continental Casualty v Argentina*<sup>36</sup> contrasted 'certain types of measures or state conduct that are considered a form of expropriation because of their material impact on property', and which give rise to compensation, and:

... limitations to the use of property in the public interest that fall within typical government regulations of property entailing mostly inevitable limitations imposed in order to ensure the rights of others or of the general public.<sup>37</sup>

The tribunal noted however that the distinction is not an easy one to make.

State parties are entitled to expropriate under BITs but specific conditions must be met; typically, the measures:

- a) must be in the public interest and under due process of law;

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<sup>33</sup> ICSID Case No ARB/01/13, Decision on Jurisdiction, 6 August 2003.

<sup>34</sup> ICSID Case No ARB/02/6, Decision on Jurisdiction, 29 January 2004.

<sup>35</sup> *Ibid* at [161].

<sup>36</sup> ICSID Case No ARB/03/9, Award, 5 September 2008.

<sup>37</sup> *Ibid* at [276].

- b) must be non-discriminatory; and
- c) are taken against just compensation, usually drafted in terms of ‘market value’.

#### vi. Fair and Equitable Treatment

The states’ obligation to accord investments fair and equitable treatment remains the most relied upon and successful basis for a treaty claim. In all 13 investor-state decisions on the merits during 2008, the arbitral tribunal addressed a fair and equitable treatment claim, and of these, the tribunal accepted seven claims.

Conventionally, a claim for breach of fair and equitable treatment usually requires some regulatory, legislative, or administrative action by a government authority which is viewed as breaching the fair and equitable treatment standard.

More recently, tribunal decisions have emphasised the increasingly prominent role of a state’s conduct which frustrates the investor’s legitimate expectations, and which as a consequence breaches the fair and equitable treatment standard. The decision in *Tecmed v Mexico*<sup>38</sup> has been consistently referred to by subsequent tribunals addressing investors’ legitimate expectations. In this context, the tribunal stated that it:

... considers that this provision of the Agreement [fair and equitable treatment], in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment ...<sup>39</sup>

Investors in recent ICSID cases have claimed breach of the fair and equitable treatment standard as a consequence of breaches by the state of the underlying contract, thereby frustrating their legitimate expectations at the time of entering into the contract. For example, in *SGS v Philippines* the tribunal held that it had jurisdiction over SGS’ claims for breach of Art IV (fair and equitable treatment) of the relevant treaty, based on SGS’ allegation that the Republic of the Philippines failed to pay a sum due under the underlying contract. The tribunal stated:

... an unjustified refusal to pay sums admittedly payable under an award or a contract at least raises arguable issues under Article IV.<sup>40</sup>

Similarly, in both *Impregilo SpA v Pakistan*<sup>41</sup> and *SGS v Pakistan*, the tribunals held that they had jurisdiction over the investors’ claims for breaches of the fair and equitable treatment provisions of the relevant treaty, based upon alleged state breaches of the underlying contracts. However, investors’ legitimate expectations cannot arise from a vacuum, but must arise from representations by the state contained in, for example, contracts or legislation.

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<sup>38</sup> ICSID Case No ARB (AF)/00/2, 23 May 2003.

<sup>39</sup> *Ibid* at [154].

<sup>40</sup> *Ibid* at [162].

<sup>41</sup> ICSID Case No ARB/03/3, Decision on Jurisdiction, 22 April 2005.

The ICSID decisions referred to above involve issues of jurisdiction, rather than decisions on the merits of an investors' claims. In these circumstances, the tribunals only have to consider whether the facts pleaded by the investor give rise to arguable issues under the relevant treaty provision. With respect to the merits of investors' claims, there is some doubt as to whether a state's breach of contract alone automatically results in a frustration of the investor's legitimate expectations and thereby, arguably, a violation of the fair and equitable treatment standard. However, there are at least some decisions on the merits of investors' claims where the tribunal has referred to the state's breaches of an underlying contract as part of the factual assessment giving rise to a breach of the fair and equitable treatment standard.<sup>42</sup>

### **vii. Full Protection and Security**

BITs also specify the requirement that investments of nationals of either contracting party shall enjoy 'full protection and security' in the territory of the other contracting party. Fair and equitable treatment is typically concerned with decision making of the organs of the state, whereas, in contrast, full protection and security is typically concerned with failures by the state to protect the investor's property from actual damage by state officials or the actions of third parties where the state has failed to exercise due diligence.

Typical full protection and security provisions are drafted as follows:

Investments of nationals of companies of either contracting party shall ... enjoy the most constant protection and security in the territory of the other contracting party.

Other formulations are used, such as, 'full', 'complete' or 'continuous' protection.

There has been a recent resurgence in claims under full protection and security provisions in BITs. In the period between 1990 and 2005 there were only six leading arbitral awards which considered this ground, whereas since 2005 there have been 24 such awards. Of these 30 awards, claimants were successful in 14 awards in establishing breach of the full protection and security provision.

The scope of the obligation is not clear from the arbitral jurisprudence. The key divergence is the extent to which the obligation extends beyond physical protection of the investment to the protection of the investor's right to own, control and enjoy the benefits of its investments. Some BITs are now drafted in terms of only providing physical security of the investment.

In *Saluka*, the tribunal stated that:

The practice of arbitral tribunals seems to indicate, however, that the 'full security and protection' clause is not meant to cover just any kind of impairment of an investor's investment, but to protect more specifically the physical integrity of an investment against interference by use of force.<sup>43</sup>

In contrast, the arbitral tribunal in *Azurix Corporation v The Argentine Republic*<sup>44</sup> came to a contrary interpretation. Azurix's claim arose from a concession agreement for water supply, which it signed with the province of Buenos Aires. Azurix alleged that the province refused

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<sup>42</sup> See, for example, *Eureka v Poland*, Ad hoc arbitration, Partial Award, 19 August 2005, at [232].

<sup>43</sup> Partial Award, 17 March 2006, at [484].

<sup>44</sup> ICSID Case No ARB/01/12, Award, 14 July 2006.

to keep rates in line with the framework outlined in its contract and did not provide promised infrastructure. Azurix, in October 2001, announced its withdrawal from the Buenos Aires contract, citing breaches of contract by the province. Azurix was successful in its arbitration claim, being awarded US\$165 million. Argentina has applied to have the award annulled under Art 52 of the ICSID Convention.

With respect to the claim for breach of the full protection and security provision in the BIT, the arbitral tribunal stated:

The Tribunal is persuaded of the interrelationship of fair and equitable treatment and the obligation to afford the investor full protection and security. The cases referred to above show that full protection and security was understood to go beyond protection and security ensured by the police. It is not only a matter of physical security; the stability afforded by a secure investment environment is as important from an investor's point of view ... when the terms 'protection and security' are qualified by 'full' and no other adjective or explanation, they extend, in their ordinary meaning, the content of this standard beyond physical security.<sup>45</sup>

### viii. Umbrella Clauses

BITs also often contain provisions commonly referred to as 'umbrella clauses' because they create a reciprocal international obligation owed by the contracting parties to each other that require them, as host states, to observe obligations they have entered into with regard to investments of investors of nationals of the other contracting party. The wording of such provisions varies between BITs, but the more widely-drafted provisions provide as follows:

Each contracting party shall observe any obligation arising from a particular commitment it may have entered into with regard to the specific investment of nationals of the other contracting party.<sup>46</sup>

The interpretation of these provisions is of great practical importance, because if interpreted in accordance with their plain and ordinary meaning, they would expand significantly the categories of disputes which investors may submit to treaty tribunals, including claims for breaches of contracts entered into by the host state. However, this is another area of interpretation where arbitral tribunal decisions are sharply divided.

The general principle under international law is that a breach of contract *per se* by the state does not give rise to direct international responsibility on the part of the state. However, to the extent that a breach of contract under the relevant local law creates at the same time a violation of one of the provisions of a treaty, it will give rise to a cause of action by reason of the breach of treaty obligation.

Umbrella clauses have the potential to introduce an exception to the above general principle by reason of the host state incurring direct international responsibility as a consequence of a breach of its contractual obligations towards a private investor of the other party, with the breach of contract being 'internationalised'.

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<sup>45</sup> *Ibid* at [408].

<sup>46</sup> Art 3(3) of the Netherlands-Republic of the Philippines BIT.

It is only comparatively recently that investors have alleged breaches of umbrella clauses in treaty claims arising from breaches by a state party of obligations of an underlying contract in an attempt to elevate the breaches of contract to a breach of treaty obligation under the relevant umbrella clause. The two ICSID cases which first considered this issue both involved the same claimant, SGS Societe Generale de Surveillance SA (SGS), with respect to its contracts with states for the provision of import supervision services.

In *SGS v Philippines*,<sup>47</sup> SGS claimed breaches of the Swiss-Republic of the Philippines BIT, including breach of Art X(2) (the umbrella clause), arising from the Republic of the Philippines' alleged breach of a contract entered into between SGS and the Republic of the Philippines for SGS to provide import supervision services. SGS alleged that it had carried out the services under the contract, and that the Republic of the Philippines had failed to pay an amount due of approximately US\$140 million, in breach of the contract. SGS claimed this amount under a number of treaty provisions, including the umbrella clause. The umbrella clause set out in Art X(2) of the BIT provides as follows:

Each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other Contracting Party.

The Republic of the Philippines challenged the tribunal's jurisdiction to hear SGS' treaty claims on a number of grounds, including that the Republic of the Philippines' claims were purely contractual, and should be dealt with under the arbitration clause contained in the contract, which the Republic of the Philippines alleged was an exclusive jurisdiction clause.

The tribunal held that it had jurisdiction over SGS' breach of contract claims *per se* under the umbrella clause, relying on the clear wording of the relevant provision:

... if commitments made by the State towards specific investments do involve binding obligations or commitments under the applicable law, it seems entirely consistent with the object and purpose of the BIT [bilateral investment treaty] to hold that they are incorporated and brought within the framework of the BIT by Article X(2).<sup>48</sup>

And:

To summarize the Tribunal's conclusions on this point, Article X(2) makes it a breach of the BIT for the host State to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments.<sup>49</sup>

With respect to the applicable law, the tribunal held that, in deciding whether the Republic of the Philippines' conduct was a breach of the underlying contract, it would apply the proper law of the contract, which in this case was Republic of the Philippines law, and in deciding whether the Republic of the Philippines' breach of the underlying contract was also a breach of the umbrella clause contained in the treaty, it would apply international law.

Whilst the tribunal considered it had jurisdiction to hear SGS' claims, and therefore by implication, that SGS' breach of contract claims were arguable under the terms of the umbrella clause, the tribunal held that the dispute resolution clause in the underlying contract was an

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<sup>47</sup> ICSID Case No ARB/02/6, 29 January 2004.

<sup>48</sup> *Ibid* at [117].

<sup>49</sup> *Ibid* at [128].

exclusive jurisdiction clause, and stayed SGS' claim under the treaty pending determination of the amount payable under the contract, in accordance with the dispute resolution clause. The decision as to whether to stay was a majority decision of the tribunal, and Professor Antonio Crivellaro (SGS' appointed arbitrator) issued a dissenting opinion on this issue. He stated:

Here, SGS claims that the Respondent has violated Article X(2) [the umbrella clause] of the BIT. The claim does not fall within the scope of Article 12 of the Contract [the dispute clause in the underlying contract], and the Tribunal has accepted to have jurisdiction over alleged contract breaches under Article X(2) of the BIT. Consequently, SGS' claim seemed to me fully admissible before our Tribunal, without first being processed before the domestic courts as to quantum matters. If our jurisdiction derives from (also) Article X(2), as unanimously admitted, I see no reason why our Tribunal could not deal with and decide on the merits of the payment claim, including quantum, after proper examination of either party's future arguments and defences.<sup>50</sup>

In a similar case decided five months earlier, *SGS v Pakistan*,<sup>51</sup> concerning SGS' equivalent contract with Pakistan for the provision of import supervision services, the tribunal came to a different conclusion on the issue of elevating claims for breach of contract to treaty claims under the relevant umbrella clause. The umbrella clause set out in Art 11 of the relevant treaty provided as follows:

Each Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party.

The tribunal held that the umbrella clause did not have the effect of elevating contract claims to treaty claims. The tribunal reasoned that, under general international law, a violation of a contract entered into by a state with an investor of another state was not by itself a violation of international law. The tribunal considered that the 'commitments' referred to in Art 11 was not specific and could be a reference to commitments of the state itself as a legal person, or any office, entity or sub-division, rather than being a reference to contractual commitments. The tribunal was also influenced by what it considered to be the far-reaching legal consequences of applying Art 11 to a state's contractual commitments in the way contended by SGS, and that any 'alleged violation of those contracts and other instruments would be treated as a breach of the BIT',<sup>52</sup>

Significantly, however, the tribunal in *SGS v Pakistan* failed to provide an alternative interpretation of the umbrella clause in question.

The tribunal in *SGS v Philippines* considered the earlier decision in *SGS v Pakistan* in its award five months later. The tribunal distinguished the wording of the umbrella clause in *SGS v Pakistan* as being 'formulated in different and rather vaguer terms'<sup>53</sup> and stated that it was 'less clear and categorical' than the phrase 'any obligation it has assumed with regard to specific investments in its territory',<sup>54</sup> in the Swiss-Republic of the Philippines Treaty. The tribunal also

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<sup>50</sup> *Ibid* at [11].

<sup>51</sup> ICSID Case No ARB/01/13, Decision on Jurisdiction, 6 August 2003.

<sup>52</sup> *Ibid* at [168].

<sup>53</sup> *Ibid* at [119].

<sup>54</sup> *Ibid* at [119].

declined to follow the reasoning of the tribunal in *SGS v Pakistan* concerning the potential wide-ranging effect of the provision, and stated that the provision ‘addresses not the scope of the commitments entered into with regard to specific investments but the performance of these obligations, once they are ascertained’.<sup>55</sup>

ICSID tribunals, in cases subsequent to the decisions in *SGS v Philippines* and *SGS v Pakistan* concerning the interpretation of umbrella clauses, have decided the issue both ways. Some tribunals have in essence followed the reasoning in *SGS v Philippines*; for example, *Eureko BV v Poland*,<sup>56</sup> *Noble Ventures Inc v Romania*,<sup>57</sup> *Siemens v Argentina*,<sup>58</sup> *LG&E Energy Corp v Argentina*,<sup>59</sup> *CMS v Argentina*,<sup>60</sup> and *Amto v Ukraine*,<sup>61</sup> whilst other tribunals have in essence followed the reasoning in *SGS v Pakistan*; for example, *Salini Costruttori SpA v The Hachemite Kingdom of Jordan*,<sup>62</sup> *Joy Mining Machinery Ltd v Arab Republic of Egypt*,<sup>63</sup> and *El Paso Energy International Co v Argentine Republic*.<sup>64</sup>

For example, the ICSID tribunal in *Eureko BV v Poland*, after considering both SGS decisions, followed the decision in *SGS v Philippines* concerning an umbrella clause in the Netherlands-Poland BIT:

The plain meaning — the ‘ordinary meaning’ — of a provision prescribing that a State ‘shall observe any obligations it may have entered into’ with regard to certain foreign investments is not obscure. The phrase, ‘shall observe’ is imperative and categorical. ‘Any’ obligations is capacious; it means not only obligations of a certain type, but ‘any’ — that is to say, all — obligations entered into with regard to investments of investors of the other Contracting Party.<sup>65</sup>

Amongst other things, the tribunal in *Eureko BV v Poland* was influenced by the fact that the umbrella clause in question was located ‘amidst the rendering of the Parties’ substantive obligations’,<sup>66</sup> unlike the equivalent clause in *SGS v Pakistan*.

Some of the cases where the tribunal followed the reasoning in *SGS v Pakistan* can be distinguished on the basis of the wording of the particular umbrella clause in question. For example, in *Salina Costruttori SpA v The Hachemite Kingdom of Jordan*<sup>67</sup> the tribunal considered that the umbrella clause in question did not in fact commit the states to ‘observe’ specific obligations, but rather, ‘only committed parties to create and maintain a legal frame work apt to guarantee the compliance of all undertakings assumed with regard to each specific investor’.<sup>68</sup>

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<sup>55</sup> *Ibid* at [126].

<sup>56</sup> Ad hoc arbitration, Partial Award, 19 August 2005.

<sup>57</sup> ICSID Case No ARB/01/11, Final Award, 2005.

<sup>58</sup> ICSID Case No ARB/02/8, 2007.

<sup>59</sup> ICSID Case No ARB/02/01, Final Award, 2006.

<sup>60</sup> ICSID Case No ARB/01/8, 12 May 2005.

<sup>61</sup> AISCC, ARB/080/2005, 26 March 2008.

<sup>62</sup> ICSID Case No ARB/02/13, Decision on Jurisdiction, 2004.

<sup>63</sup> 19 ICSID Rev-FILJ 486, Decision on Jurisdiction, 2004.

<sup>64</sup> ICSID Case No ARB/03/15, Decision on Jurisdiction, 27 April 2006.

<sup>65</sup> Ad hoc arbitration, Partial Award, 19 August 2005, at [246].

<sup>66</sup> *Ibid* at [259].

<sup>67</sup> ICSID Case No ARB/00/4, 23 July 2001.

<sup>68</sup> *Ibid* at [126].

In the cases referred to above, all of the claimants (with the exception of *Amto v Ukraine* and *CMS v Argentina*, which are discussed below) were actually parties to the underlying contract, and were at the same time, relying on the umbrella provision in the relevant treaty. As a matter of principle, there should be no restriction on an indirect investor relying upon an umbrella clause drafted in terms of '[e]ach contracting party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other contracting party' since this provision does not state to whom the contractual obligation must be owed.

In *Siemens v Argentina*,<sup>69</sup> the tribunal held that the relevant umbrella clause in question covered contractual disputes, following the decision in *SGS v Philippines*. However, the tribunal also commented that in order for the clause to cover contractual obligations, such obligations must originate in a contract between the state party to the treaty and the foreign investor, as in the *SGS* cases. The tribunal in *Siemens* gave no reasoning for this view.

Arguably, the tribunal's comment on this issue was not necessary for the purpose of its decision, since the tribunal ultimately found against Argentina, and the issue of whether the claimant could claim under the umbrella clause may have appeared superfluous to the tribunal. The comment is also inconsistent with the plain wording of the relevant umbrella clause considered by the tribunal.<sup>70</sup>

A similar comment was made by the tribunal in the recent case of *Plama Consortium Limited v Bulgaria*,<sup>71</sup> where the tribunal supported the umbrella clause as applying to contract claims, but stated that these obligations must be between the host state and the investor, as follows:

The Tribunal can limit itself to noting that the wording of this clause in Article 10(1) [the umbrella clause] ... is wide in scope since it refers to 'any obligation'. An analysis of the ordinary meaning of the term suggests that it refers to any obligation regardless of its nature, i.e. whether it be contractual or statutory. However, the ad hoc Committee that decided the annulment in the case, *CMS v Argentina*, commented that the use of the expression 'entered into' should be interpreted as concerning only consensual obligations. In any case, these obligations must be assumed by the host State with an Investor (*Impregilo v Pakistan*, Decision on Jurisdiction of 22 April 2005, paras 214–216).

Following either the wide interpretation of the clause or the more restricted one proposed by the ad hoc Committee, contractual obligations are covered by the last sentence of Article 10(1).<sup>72</sup>

Again, the tribunal in *Plama* provided no reasoning for this view. It appears to have relied on the decision in *Impregilo v Pakistan*,<sup>73</sup> in which the tribunal in that case held that it did not have jurisdiction under the relevant treaty to consider breaches of contract entered into between a government linked entity, the Pakistan Water and Power Development Authority (WAPDA) and *Impregilo*, since WAPDA was a separate legal entity under Pakistan law. In fact, in *Impregilo v*

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<sup>69</sup> ICSID Case No ARB/02/8, 2007.

<sup>70</sup> The history of the development of umbrella clauses in international treaty obligations also supports the interpretation adopted by the tribunal in *SGS v Philippines*: see A Sinclair, 'The Origins of the Umbrella Clause in the International Law of Investment Protection' (2004) 20 *Arbitration International* 411.

<sup>71</sup> ICSID Case No ARB/03/24, 27 August 2008.

<sup>72</sup> *Ibid* at [186]–[187].

<sup>73</sup> ICSID Case No ARB/03/3, Decision on Jurisdiction, 22 April 2005.

*Pakistan*, there was no umbrella clause in the relevant treaty. This decision therefore does not appear to support the tribunal's view as to the application of umbrella clauses *per se*.

In contrast, the tribunal in *CMS v Argentina*, in its award on the merits, gave effect to the umbrella clause for breaches of the underlying contract in circumstances where CMS was an investor shareholder in the contracting party, TNG. However, the tribunal was of the view that breaches of purely commercial aspects of the underlying contract might not be protected in some situations.<sup>74</sup> The tribunal's decision on the umbrella clause issue was annulled by an ad hoc committee (*CMS v Argentina*)<sup>75</sup> upon Argentina's application on the basis that the tribunal had not adequately set out its reasons on this issue. The committee also questioned the tribunal's conclusion on the application of the umbrella clause to investors.

The tribunal in *Amto v Ukraine*<sup>76</sup> gave support for an investor's claim under the umbrella clause, since the tribunal held that the claimant, an investor in a Ukraine entity (EYUM-10), could rely on the umbrella clause for breaches of contract entered into between the host state and EYUM-10. However, the tribunal declined to apply the clause because the state party was in fact a separate legal entity. The tribunal stated:

The so-called 'umbrella clause' of the ECT [the Energy Charter Treaty] is of a wide character in that it imposes a duty to the Contracting Parties to 'observe any obligations it has entered into with an Investor or an Investment of an Investor of the other Contracting Party'. This means that the ECT imposes a duty not only in respect of the investor which is otherwise customary in an investment treaty context, but also vis-à-vis a subsidiary company, established in the host state. This means that an undertaking by Ukraine of a contractual nature vis-à-vis EYUM-10 could very well bring into effect the umbrella clause. However, in the present case the contractual obligations have been undertaken by a separate legal entity, and so the umbrella clause has not direct application.<sup>77</sup>

In an analogous situation in *Impregilo SpA v Pakistan*,<sup>78</sup> the tribunal declined to stay the ICSID arbitration proceedings with respect to alleged breaches of Art 2(2) (fair and equitable treatment) and Art 5 (expropriation) of the relevant treaty, even though Impregilo's claims were based on alleged breaches by Pakistan of the underlying contract. One of the tribunal's reasons for proceeding to hear the substantive treaty claims was that, unlike in *SGS v Philippines*, the parties in the treaty arbitration proceedings were different from the parties to the arbitration proceedings under the underlying contract, since *Impregilo* was only one of a number of joint venture partners in the underlying contract.

The wording of umbrella clauses varies significantly among BITs, including the level of specificity regarding the undertakings covered. Arbitral tribunals often draw subtle distinctions between different wording to distinguish previous decisions. Investors should analyse the wording carefully before attempting to rely on the terms of the umbrella clause.

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<sup>74</sup> ICSID Case No ARB/03/24, 27 August 2008, at [299].

<sup>75</sup> ICSID Case No ARB/01/8.

<sup>76</sup> AISCC, ARB/080/2005, 26 March 2008.

<sup>77</sup> *Ibid* at [110].

<sup>78</sup> ICSID Case No ARB/03/3, Decision on Jurisdiction, 22 April 2005.

## 4. Most Favoured Nations Clauses

Many BITs contain provisions commonly referred to as ‘most favoured nations clauses’ (MFN clause). The general principle is that the beneficiary of an MFN clause is entitled to the more favourable treatment accorded by the state party to the nationals of a third country. The more favourable treatment is found in a ‘third-party treaty’, which then governs the rights of the beneficiary of the MFN clause. The rationale for the MFN standard in the context of BITs is to prevent discrimination against the nationals of different countries, and ensure equality of treatment by the host state regardless of the nationality of investors.

MFNs therefore allow investors to ‘treaty shop’ for provisions in third-party treaties that may be more favourable than those contained in the original treaty. Typically, MFN clauses are drafted in the following terms:

Each contracting party shall extend to investments, in its territory, of nationals of the other contracting party treatment no less favourable than that granted to investments of nationals in any third state.<sup>79</sup>

It is well established that the beneficiary of an MFN clause can invoke the substantive rights of a third-party treaty. The question of whether an MFN clause can have the effect of widening the scope of jurisdiction is more difficult. In one of the leading early cases on the issue of the effect of MFN clauses in this context, the tribunal stated that a clear distinction must be drawn between:

... the legitimate extension of rights and benefits by means of the operation of the [MFN] clause, on the one hand, and disruptive treaty-shopping that would play havoc with the policy objectives of underlying specific treaty provisions, on the other hand.<sup>80</sup>

The issue addressed by tribunals on jurisdiction in the context of MFN clauses has concerned the question of whether it is permissible for an investor to use the MFN clause in the BIT applicable to its dispute as a means of establishing jurisdiction for an arbitral tribunal under third-party treaty dispute clauses where jurisdiction could not otherwise be established. In these cases, the investor has usually failed to comply with a condition precedent to arbitration contained in the relevant BIT, and has sought to invoke a less restrictive arbitration clause contained in a third-party BIT in order to commence arbitration proceedings.

Even on this narrow jurisdictional issue, tribunals are divided on the effect of MFN clauses. After initially allowing such an extension, tribunals in more recent cases have been reluctant to allow an MFN clause to subvert the carefully negotiated terms of a BIT to increase the dispute resolution jurisdiction.<sup>81</sup>

The tribunal in *Emilio Agustín Maffezini v the Kingdom of Spain*,<sup>82</sup> the first tribunal to consider the issue, applied the MFN clause in the Argentina-Spain BIT to provide the claimant with the

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<sup>79</sup> Article 4(1) of the Netherlands-Republic of the Philippines BIT.

<sup>80</sup> *Emilio Agustín Maffezini*, ICSID Case No ARB/97/7, Decision on Jurisdiction, 25 January 2000.

<sup>81</sup> *Plama Consortium Ltd v Republic of Bulgaria*, ICSID Case No ARB/03/24, Decision on Jurisdiction, 25 January 2000; and *Salini Costruttori SpA v The Hashemite Kingdom of Jordan*, ICSID Case No ARB/02/13, Decision on Jurisdiction, 15 November 2004.

<sup>82</sup> ICSID Case No ARB/97/7, Decision on Jurisdiction, 25 January 2000.

more favourable dispute resolution provisions contained in the Chile-Spain BIT as part of the substantive protection extended to the beneficiary of the clause. The Argentina-Spain BIT dispute provisions provided for a six-month negotiation phase before the dispute could be submitted to the competent courts of the host state and, failing settlement of the dispute after the expiry of eighteen months, to international arbitration under the auspices of ICSID or an ad hoc tribunal under the UNCITRAL Rules. Mr Maffezini did not comply with the requirement to submit the dispute to the Spanish courts.

With respect to the application of the MFN to the disputes provisions, the tribunal stated:

[T]he Tribunal considers that there are good reasons to conclude that today dispute settlement arrangements are inextricably related to the protection of foreign investors ... if a third party treaty contains provisions for the settlement of disputes that are more favourable to the protection of the investor's rights and interests than those in the basic treaty, such provisions may be extended to the beneficiary of the most favoured nation clause ...<sup>83</sup>

The principle set out by the tribunal in *Maffezini* was subsequently followed in 2004 by the arbitral tribunal in *Siemens AG v The Republic of Argentina*,<sup>84</sup> where the tribunal allowed Siemens to apply the more favourable dispute resolution provision in the Chile-Argentina BIT by commencing arbitration after a six month negotiation phase, rather than the more restrictive requirements in the Germany-Argentina BIT to exhaust local Argentine remedies during an 18-month period. The tribunal accepted that the reference in the MFN clause to 'treatment' was narrower than the reference in the MFN clause considered by the tribunal in *Maffezini*, which referred to 'all matters subject to this agreement', but nevertheless considered that the term was sufficiently wide to include settlement of disputes.<sup>85</sup>

The decisions in *Maffezini* and *Siemens* are consistent with the view that dispute resolution provisions are part of the substantive protection to be accorded investors and their investments. However, these two decisions were followed by the tribunal's decision in *Plama Consortium Ltd v Republic of Bulgaria*,<sup>86</sup> which rejected the approach in *Maffezini* and *Siemens*, and considered that the wording of an MFN clause should be 'clear and unambiguous' in its reference to arbitration.

Consistent with this stricter approach in *Plama* is the recent decision of an ICSID tribunal in *Wintershall Aktiengesellschaft v Argentina*.<sup>87</sup> In this case, the tribunal declined jurisdiction over a claim by a German investor, refusing to permit the investor to invoke the MFN clause in the Germany-Argentina BIT, in order to dispense with an 18-month period in which investors must pursue their claims before local courts. This decision was directly contrary to the earlier decision of the tribunal in *Siemens AG v Argentine Republic*, applying the same MFN clause in the Germany-Argentina BIT.<sup>88</sup>

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<sup>83</sup> *Ibid* at [54]–[56].

<sup>84</sup> ICSID Case No ARB/02/8, Decision on Jurisdiction, 3 August 2004.

<sup>85</sup> *Ibid* at [103].

<sup>86</sup> ICSID Case No ARB/03/24, Decision on Jurisdiction, 8 February 2005.

<sup>87</sup> ICSID Case No ARB/04/14, Decision on Jurisdiction, 8 December 2008.

<sup>88</sup> ICSID Case No ARB/02/8, Decision on Jurisdiction, 3 August 2004.

This leads to the most recent decision. In *RosInvestCo UK Ltd v The Russian Federation*,<sup>89</sup> and *Renta 4 S.V.S.A. v The Russian Federation*,<sup>90</sup> tribunals in both cases considered expansion of their jurisdiction to disputes that they would not otherwise have jurisdiction to determine by application of an MFN clause, rather than a claimant simply attempting to overcome pre-conditions to arbitration in the basic treaty, as in *Maffezini* and *Siemens*.

In *RosInvestCo*, the claimant's right to refer a dispute to international arbitration under the United Kingdom-Soviet Union BIT was limited in Article 8(1) to those disputes concerning the amount or payment of compensation arising from expropriation. As an alternative to the claimant's arguments on interpretation of Article 8(1), the claimant sought to invoke the MFN clause in Art 3(2) of the BIT to apply the more favourable dispute resolution provisions in Art 8 of the Denmark-Russia BIT.

The tribunal did not expressly refer to the approach adopted by the tribunal in *Maffezini*, but rather emphasised the wording of the MFN provision, which granted protection for 'investors' regarding 'their management, maintenance, use, enjoyment or disposal of their investments', but it is clear from the tribunal's reasoning of equating an investor's right to refer disputes to international arbitration with substantive rights, that the tribunal's approach is consistent with the reasoning in *Maffezini*.

In *Renta 4*, the claimants sought to overcome the restriction on referring disputes to international arbitration contained in Art 10(1) of the Spain-Soviet Union BIT by arguing in the alternative that the MFN clause contained in Art 5 of the BIT allowed them to submit the dispute to international arbitration.

The claimant argued that Russia is a party to BITs with third states containing liberal arbitration clauses, and, like the claimant in *RosInvestCo*, invoked Art 8(1) of the Denmark-Russia BIT, which gives an investor unrestricted right to submit 'any dispute' to international arbitration. The MFN clause contained in Art 5(2) of the BIT provides as follows:

The treatment referred to in paragraph 1 [the fair and equitable treatment guarantee] shall be no less favourable than that accorded by either Party in respect of investments made within its territory by investors of any third State.

The tribunal noted that various arbitral awards dealing with the jurisdictional implications of an MFN clause have taken divergent views, and that a *jurisprudence constante* of general applicability is not yet firmly established.

The tribunal accepted the general proposition that MFN clauses should apply to arbitration provisions, referring with approval to the approach in *RosInvestCo*,<sup>91</sup> and the International Court of Justice decision in *Ambatelios*,<sup>92</sup> and stressed that there is no significant distinction between

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<sup>89</sup> Award in Stockholm under the auspices of the Arbitration Institute of the Stockholm Chamber of Commerce, October 2007.

<sup>90</sup> Award on jurisdiction in Stockholm under the auspices of the Arbitration Institute of the Stockholm Chamber of Commerce, 20 March 2009.

<sup>91</sup> Award in Stockholm under the auspices of the Arbitration Institute of the Stockholm Chamber of Commerce, October 2007.

<sup>92</sup> 23 ILR 306.

‘procedural’ investor protection and ‘substantive’ investor protection. However, in interpreting Article 5(2), the majority of the tribunal was of the view that the MFN clause was unusually worded, and only provides investors a no-less favourable level of fair and equitable treatment, and did not apply to arbitration provisions contained in third party BITs.

The tribunal did not discuss the decision four months earlier in *Wintershall*, but it is clear from the tribunal’s reasoning in *Renta 4* that there is a clear dichotomy in approach between the two tribunals, since in *Wintershall* the tribunal followed *Plama* and considered that there would need to be ‘clear and unambiguous wording’ in the MFN clause for the provision to relate to an arbitration clause in a third party treaty. It is also clear from the tribunal’s reasoning that had the MFN clause been worded in more usual terms, the tribunal would have extended the application of the clause to more favourable third party treaty dispute provisions.

This decision has significant consequences for investors subject to restrictive provisions in BITs to refer a limited range of disputes to international arbitration because it potentially allows investors to invoke MFN clauses to refer ‘any dispute’ to international arbitration, rather than being used only to overcome pre-conditions to arbitration, as in *Maffezini* and *Siemens*.

## 5. Dispute Resolution

### ix. Introduction

The majority of BITs prescribe a period within which parties are not entitled to bring claims pending settlement attempts, referred to as the ‘cooling-off period’. These periods can vary from as little as three months up to 12 months.

In practice, tribunals have generally not penalised claimants for failing to observe cooling-off periods. For example, in *Bayindir v Pakistan*,<sup>93</sup> Pakistan objected to the tribunal’s jurisdiction on the basis that Bayindir had failed to give any notice of its claim, as required under the Turkey-Pakistan BIT, and was thus not entitled to submit a dispute to arbitration. However, there is a minority of tribunals which have decided the point differently, and held that the cooling-off period was in fact a jurisdictional requirement.<sup>94</sup>

Where a claimant fails entirely to give advance warning of its intention to commence proceedings, the state party could argue that the tribunal lacks jurisdiction on the basis that there is no ‘dispute’ between the parties.

The cooling-off period is then followed broadly by two categories of dispute resolution provisions:

- a) a ‘cafeteria style’ approach where there is a range of dispute settlement options for the claimant to accept; for example, submission to state courts, ICSID arbitration, *ad hoc* arbitration under the UNCITRAL Rules, or institutional arbitration such as ICC; or
- b) a preferred dispute settlement, usually ICSID arbitration.

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<sup>93</sup> ICSID Case No ARB/03/29, Decision on Jurisdiction, 2005.

<sup>94</sup> *Goetz v Burundi*, 6 ICSID Rep 3, 32, 1999.

BITs entered into by a single country differ in the extent to which investors are entitled to have recourse to international arbitration for the resolution of disputes. For example, and relevantly for Australia, Art XII(1)(b) of the Australia-China BIT permits an investor to submit to arbitration, after a three month cooling-off period, but only where the dispute relates to the amount of compensation payable under Art VIII (relating to expropriation and nationalisation).

With respect to whether terms such as Art XII(1)(b) of the Australia-China BIT gives an arbitral tribunal the jurisdiction to determine whether there has been expropriation in the first place, support for a restricted application of these provisions stems from the decisions of the investor-state arbitral tribunals in *Vladimir and Moise Berschader v Russian Federation*,<sup>95</sup> which involved a claim by Belgian nationals under the Belgium-Luxembourg Economic Union-Soviet Union BIT, and *RosInvestCo UK Ltd v The Russian Federation*,<sup>96</sup> which involved a claim by United Kingdom nationals under the United Kingdom-Soviet Union BIT. In both cases, the tribunals held that they did not have jurisdiction under the relevant provisions to consider whether expropriation had occurred in the first place and was legal. This issue had to be decided first by the respective national courts before the tribunals could consider the amount of compensation payable.

However, this situation may have changed following two more recent investor-state decisions. Both the arbitral tribunal in *Renta 4 S.V.S.A. v The Russian Federation*,<sup>97</sup> and the English High Court in *The Czech Republic v European Media Ventures SA*,<sup>98</sup> held that similarly worded restrictions in the respective BITs gave the arbitral tribunal jurisdiction not only to hear disputes concerning the amount of compensation arising from expropriation by the state, but also whether expropriation had occurred in the first place, directly contrary to the decisions in *Berschader* and *RosInvestCo*.

In contrast to Art XII(1)(b) of the Australia-China BIT, Art 7 of the United Kingdom-China BIT permits an investor to submit a dispute concerning ‘an amount of compensation’ to ad hoc international arbitration under the UNCITRAL Rules. The requirement of nationality is achieved under Art 1(1)(c) of the BIT simply by incorporation of a company in the United Kingdom, with no further restrictions. Australian companies could therefore structure their investment through the United Kingdom or some suitable third country with a similarly investor-friendly BIT with China.

These differences raise the potential for Australian companies being able to structure their investments through third party countries with more favourable BIT terms than those in the Australia-China BIT.

#### x. The Requirement for Consent

The analysis adopted to establish agreement to arbitrate in terms of ‘consent in writing’<sup>99</sup> under the auspices of the Centre is that the dispute provisions set out in the BIT contain a standing

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<sup>95</sup> Award in Stockholm under the auspices of the Arbitration Institute of the Stockholm Chamber of Commerce, 21 April 2006.

<sup>96</sup> Award in Stockholm under the auspices of the Arbitration Institute of the Stockholm Chamber of Commerce, October 2007.

<sup>97</sup> Award on jurisdiction in Stockholm under the auspices of the Arbitration Institute of the Stockholm Chamber of Commerce, 20 March 2009.

<sup>98</sup> [2007] EWHC 2851, 5 December 2007.

<sup>99</sup> Pursuant to Art 25(1) of the ICSID Convention.

consent or offer in advance by the state party, which a qualified investor can accept by submitting to the Centre a Request for Arbitration. However, the provisions can sometimes be ambiguous as to whether something further is needed from the state party for the arbitration agreement to be effective. For example, the terms of Art 9(1) of the France-Republic of the Philippines BIT provides as follows:

... the Contracting Party which is party to the dispute shall assent to any request on the part of the national or company party to the dispute to submit it; for conciliation or arbitration, to the International Centre for the Settlement of Investment Disputes (ICSID) created by the Convention for the settlement of disputes in respect of investments occurring between States and nationals of other States signed in Washington on March 18, 1965.

The state party is likely to argue that the reference to ‘shall assent’ in Art 9(1) requires a further consent by the state party following the investor submitting a request to the state for the dispute to be decided by arbitration under the auspices of the Centre. Whilst a failure by the state party to give such consent is a breach of the BIT, the remedy is between the two contracting state parties, rather than between the investor and the state party. An alternative approach would be to argue that the MFN is applicable to import more favourable dispute resolution provisions from a third-party BIT, as discussed above.

#### **xi. Outline of ICSID Arbitration Procedure**

All BITs allow for disputes to be resolved by international arbitration, rather than through the host state’s national courts, and usually provides at least the option for an investor to refer the dispute for arbitration under the auspices of the Centre, established under the ICSID Convention. The ICSID Convention was conceived by the World Bank to provide a neutral forum in the shape of ad hoc arbitration tribunals to resolve disputes between investors of signatory states and the states themselves. Australia is a signatory to the ICSID Convention (1975, entry into force in 1991). Approximately 60% of all investor-state disputes are heard under the auspices of the Centre.

The procedure is principally contained in the Centre’s Rules of Procedure for Arbitration Proceedings (the Arbitration Rules). However, parts of the convention are also relevant, together with the Centre’s Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (the Institution Rules).

Whilst the Arbitration Rules are designed specifically for investor-state arbitrations, the Arbitration Rules contain many of the features in the common arbitration rules for international commercial arbitration. For example:

- a) request for arbitration;
- b) appointment and qualifications of members of the arbitral tribunal;
- c) written pleadings setting out the parties’ respective cases;
- d) submission of written and oral evidence of fact;
- e) submission of expert evidence;
- f) procedure for hearing;
- g) powers of tribunal;

- h) publication of award;
- i) challenges to an award; and
- j) fees.

Unless the parties agree otherwise, the arbitration hearing itself takes place at the Centre's facilities in Washington DC. The location of the hearing itself is irrelevant to the choice of the seat in ICSID arbitrations, since the Convention has a self-contained system for enforcement of ICSID awards. Pursuant to Art 54 of the Arbitration Rules, state national courts have no power to review ICSID awards, and must treat the award as a judgement of its own highest court.

ICSID awards are final and binding, with only limited challenges permissible, all of which are related to the requirement for due process. Pursuant to Art 52 of the Arbitration Rules, the grounds for annulment of an ICSID award are limited to:

- a) improper constitution of the tribunal;
- b) manifest excess of powers by the tribunal;
- c) arbitrator corruption;
- d) serious departure from a fundamental rule of procedure; and
- e) failure to state the reasons on which the award was based.

#### **xii. Constitution of the Tribunal**

Rule 2 of the Arbitration Rules sets out a procedure for the parties to attempt to agree on the number of arbitrators and the method of their appointment. In the event that this procedure fails to result in agreement, the default provisions provide for a three-member tribunal, with each party appointing an arbitrator, and Chairman of the Administrative Council appoints the President of the tribunal.

The net result is that it can take up to four months from registration of the Request for Arbitration to fully constitute the arbitral tribunal.

#### **xiii. Request for Arbitration**

Pursuant to Art 36(1) of the Convention, a national of a contracting state wishing to institute arbitration proceedings shall submit a written request to the Secretary-General of the Centre. The Secretary-General is the legal representative and principal officer of the Centre. The Secretary-General is obliged to send a copy of the Request for Arbitration to the opposing party. The Centre also sends a copy of the Request to the relevant Washington embassy of the relevant state party.

The requirements for the contents of the Request for Arbitration are set out in r 2 of the Institution Rules, and are designed to allow the claimant to demonstrate that it satisfies jurisdictional criteria for an ICSID arbitration. The claimant must:

- a) indicate the instrument in which the parties' consent to the Centre arbitration is contained;
- b) provide the address of each party;
- c) state the claimant's nationality;
- d) provide information concerning the issues in dispute indicating that there is, between the parties, a legal dispute arising directly out of an investment (mirroring the wording of Art 25(1) of the Convention).

In practice, the Centre is concerned to only register Requests for Arbitration where there are good arguments that an arbitral tribunal will have jurisdiction over the claim. The Centre assigns a senior counsel to review the contents of the Request for Arbitration, and if necessary, to correspond with the claimant on any further information required from the claimant. This review process takes approximately two months to register the Request for Arbitration.

#### **xiv. Time to Obtain an Award**

The period in which a claimant can obtain an award depends on whether there are substantial jurisdictional challenges. If there are no jurisdictional challenges, an award on the merits can be achieved within a period of 2–2.5 years. Where there are jurisdictional challenges or applications for annulment, this period can be as long as four or five years. For example, in *Malaysian Historical Salvors v The Government of Malaysia*,<sup>100</sup> the Request for Arbitration was first registered with the Centre in June 2005, and the sole arbitrator published his award on jurisdiction in May 2007. The claimant applied for annulment of the sole arbitrator's award on jurisdiction, which was published in April 2009, almost four years from registration of the Request for Arbitration in circumstances where the substantive claim has not yet been heard by an ICSID Tribunal.

## **6. Conclusions**

Investor-state arbitration is a growing area of international law. In many areas of interpretation of jurisdictional and substantive protection provisions of treaties, the law is in a state of development, and there has been a trend of divergent interpretations by international tribunals, resulting in a growing number of conflicting awards. This is a reflection of the two broad approaches to treaty interpretation: interpretation from the point of view of policy; and interpretation from the point of view of application of rules of law.

The investor treaty network has also been criticised as serving primarily the interests of western nations, and the investor-state dispute resolution system favouring western nations. This is coupled with an on-going debate about possible negative effects of foreign direct investment. This has resulted in a trend of more states emphasising that investment must not be pursued at the expense of other legitimate public concerns, leading to more states seeking recourse to wider exceptions to safeguard the right of the host country to enact regulations in such diverse fields as essential security and public order, protection of health, safety and natural resources, cultural diversity, and prudential measures for financial services.<sup>101</sup>

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<sup>100</sup> ICSID Case No ARB/05/10, 16 April 2009.

<sup>101</sup> 'Bilateral Investment Treaties 1995-2006: Trends in Investment Rulemaking', UNCTAD, 2007.

# **FOREIGN DIRECT INVESTMENT: AN AUSTRALIAN PERSPECTIVE**

**Leon Trakman\***

## **Abstract**

Foreign Direct Investment (FDI) is both an opportunity to contribute to economic and political development and a hindrance. On the one hand, FDI represents an opportunity to extend public participation in international investment and to promote access to FDI by private investors. On the other hand is concern that FDI may be predatory, invasive of Australia's public interests and impact negatively on some domestic industries. Resolving these tensions is not self-evident. The regulation of FDI needs to be not only stable and even-handed, but also sensitive to domestic socio-cultural, economic and political demands. It should have a coherent structure and yet be flexible enough to suit the FDI regime in issue. Australia's dilemma is to establish its economic interdependence within a global coalition of investing nations without becoming unduly dependent on foreign infrastructures and resources. Its challenge is to strengthen its domestic economy with support of foreign investment without threatening vulnerable and sensitive sectors of the economy in the process.

This article explores these issues in light of customary principles of international investment law, trade and investment conventions, such as the United National Commission on International Trade Law (UNCITRAL). It considers the decisions of international investment tribunals such as the International Centre for Settlement of Investment Disputes (ICSID) and the domestic restrictions imposed on FDI through the police and related powers of domestic countries, including but not limited to Australia. It also emphasises the development of Free Trade Agreements (FTAs) and Bilateral Investment Agreements (BITs), such as under Ch 11 of the North American Free Trade Agreement (NAFTA), and the more recent Australia-United States Free Trade Agreement (AUSFTA).

This article gives particular emphasis to the need to appreciate salient differences in investment treaty protocols, the distinctive manner in which state-investment tribunals have construed them in the event of FDI disputes, and how these constructions may influence FDI practices in the future. Given the fluidity of FDI and its international and domestic regulation, the article does not present wholly predictable legal responses to investment conduct. Instead, it focuses on developing an understanding about key issues involved in FDI planning, including giving due account to different investment treaties and the prospect of FDI practices being treated differently in different international and domestic legal contexts.

## **7. Introduction**

FDI represents both an opportunity to contribute to economic and political development, and a hindrance to Australia, foreign investors in Australia and Australian investors abroad, depending on the vantage point of the observer. On the one hand, FDI represents an opportunity to contribute to development in Australia and elsewhere by extending public participation in international investment, and to promote access by private investors to FDI. On the other hand are the recessionary forces in which FDI is conceived as predatory, invasive of Australia's public interests as well as those of negatively impacted domestic

industries. An issue for Australia is the realisation that, by expanding FDI, the domestic Australian economy may progress. In doubt is whether that progress is sustainable and whether it will have an affirmative impact on producer and consumer markets, sensitive domestic industries, employment and the environment.<sup>1</sup>

A subtext over the utility of FDI is tension over both its international and domestic regulation. That tension is coupled with a tenuous relationship between maintaining *laissez faire* international markets for FDI and preserving Australia and Australians from the economic, social and political inroads that FDI inevitably produces.<sup>2</sup> On one side of the coin is the need to ensure that foreign direct investors are treated equitably in Australia. On the other side is the need to preserve natural resources and the related public interests of Australia as a whole. Overriding both is the need for a principled and transparent regime governing FDI that accommodates state and non-state interests not limited to foreign direct investors.<sup>3</sup>

Evaluating these tensions involves carefully weighing competing regulatory strategies. If foreign investment in Australia is to be stable, the regulatory regime governing FDI needs to be, not only both even-handed and coherent, but also sensitive to domestic socio-cultural, economic and political demands. Absent predictability in regulating FDI, investment opportunities in Australia and of Australians abroad may regress into investor-state conflict and a waste of resources. In the absence of a structure that is consistent yet flexible, the

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\* Professor of Law and Immediate Past Dean of Law, University of New South Wales, Sydney, Australia, B Com LLB (Cape Town); LLM, SJD (Harvard). The author is active as a Chapter 19 NAFTA panellist and has served on the Canadian Chapter 11 Roster on investment. For further information on his academic and professional background, see <<http://www.trakmanassoc.com>>. This article draws from an upcoming book on international business law, including international investment law, co-authored with Bryan Mercurio (Oxford, Australia, 2009), and research for a further book on international investment law, to be published by Oxford University Press, New York, co-authored with Nick Ranieri. Particular thanks are owed to Jürgen Kurtz, Bryan Mercurio and Nick Ranieri for their comments.

<sup>1</sup> On the international investment issues facing the Australian Government, see <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>. On the AUSFTA, see *supra* s 10. For terms or proposed terms of the different investment agreements Australia has or is negotiating, see <<http://www.dfat.gov.au/geo/china/fta/>> (China); <<http://www.dfat.gov.au/geo/malaysia/fta/index.html>> (Malaysia); <<http://www.dfat.gov.au/trade/fta/asean/index.html>> (ASEAN); <<http://www.dfat.gov.au/geo/uae/fta/index.html>> (United Arab Emirates); <<http://www.dfat.gov.au/geo/japan/fta/index.html>> (Japan).

<sup>2</sup> See Karl P Sauvart, *Yearbook on International Investment Law & Policy* 2008-2009(2009); Peter Muchlinski, Federico Ortino and Christoph Schreuer, (eds), *The Oxford Handbook of International Investment Law* (2008); Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2008); W Shan, P Simons and D Singh, *Redefining Sovereignty in International Economic Law* (2008); R Stumberg, 'Sovereignty by Subtraction: The Multilateral Agreement on Investment' (1998) 31 *Cornell Int'l LJ* 491; C Jonathan, *Sovereignty and the International Regulation of Foreign Direct Investment* (paper presented at the annual meeting of the American Political Science Association, 28 Aug 2002), <[http://www.allacademic.com/meta/p65530\\_index.html](http://www.allacademic.com/meta/p65530_index.html)>. See also J H Jackson, *Quasi-States: Sovereignty, International Relations and the Third World* (1991); J H Jackson, *The Jurisprudence of Gatt and the WTO: Insights on Treaty Law and Economic Relations* (2000); M Reisman, 'International Arbitration and Sovereignty' (2002) 18(3) *Arbitration International* (LCIA); Sir Robert Jennings and Sir Arthur Watts (eds), *Oppenheim's International Law* (1992) 927.

<sup>3</sup> For a classical treatment of this subject, see L B Sohn and R R Baxter, 'Responsibility of States for Injuries to the Economic Interests of Aliens' (1961) 55 *Am J Int'l L* 545. See also G Lew and J Heilman Grier, 'A Role for Governments in the Resolution of International Private Commercial Disputes' (1995) 18 *Fordham Int'l J* 1720; F Michelman, 'Property Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law' (1967) 80 *Harv L Rev* 1165. On the powers and duties of states under a Hohfeldian analysis of rights and duties, see L E Trakman and S Gatién, *Rights and Responsibilities* (1999) Chs 1–2.

process of international investment may degenerate into an unstable cycle of economic and social dislocation.<sup>4</sup>

This article explores these issues in light of customary principles of international investment law, trade and investment conventions such as UNCITRAL<sup>5</sup> and the decisions of international investment tribunals such as under ICSID<sup>6</sup> and domestic restrictions imposed on FDI through the police and related powers of domestic countries, including but not limited to Australia.<sup>7</sup> Emphasis is also given to the development of FTAs and BITs. Illustrating dispute resolution mechanisms in FTAs are those established under Ch 11 of NAFTA, contrasted with provisions under the more recent AUSFTA.<sup>8</sup> The following list of issues is considered to varying degrees in the sections that follow:

Section 1: identifies the key issues identified with FDI.

Section 2: evaluates the content of FDI.

Section 3: evaluates the relationship between the domestic state and the foreign investor.

Section 4: analyses the regulation of FDI including from Australia's perspective.

Section 5: considers the history and traditions governing FDI in the post-World War II era, varying from Treaties of Friendship, Commerce and Navigation (FCNTs), multilateral investment agreements of the World Trade Organisation (WTO), and BITs.

Section 6: evaluates alternative models for resolving FDI disputes, including through investor-state tribunals, and through domestic courts notably under the AUSFTA.

Section 7: evaluates existing institutions and mechanisms that are used to resolve investor-state disputes under the ICSID, the ICSID Additional Facility and the UNCITRAL.

Section 8: explores legal restrictions that states may impose upon FDI under international law including the functional significance of those restrictions.

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<sup>4</sup> On Australia's existing and impending FTAs and BITs, see Bilateral Agreements at <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>5</sup> The international investment agreements under the UNCITRAL are available at <<http://www.unctad.org/Templates/StartPage.asp?intlItemID=2310&lang=1>>. See also UNCITRAL Arbitration Rules, GA Res 31/98, UN UNCITRAL, 99th Plen Mtg (15 Dec 1996) (UNCITRAL Rules), available at <<http://www.uncitral.org/pdf/english/texts/arbitrationarb-rules/.pdf>>. ICSID Additional Facility Rules are available at the World Bank website: <<http://www.worldbank.org/icsid/basic-doc-archive/9.html>>.

<sup>6</sup> See ICSID Additional Facility Rules: <<http://www.worldbank.org/icsid/basic-doc-archive/9.html>>. See also C H Schruer, *The ICSID Convention: A Commentary on the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States* (2001).

<sup>7</sup> For commentary on the development of international investment law and practice, see, Stephan W Schill, *The Multilateralization of International Investment Law, Cambridge International Trade and Economic Law Series*, Max Planck Institute for Comparative Public Law and International Law (2009); Campbell McLauchlan QC, Laurence Shore and Matthew Weiniger, *International Investment Arbitration: Substantive Principles* (Oxford International Publ, 2007); *ICSID Review*, International Centre for Settlement of Investment Disputes (1986-); *J World Inv't & Trade* (2004-).

<sup>8</sup> On the Australia-US Free Trade Agreement, see *infra* s 10. On investment disputes under the NAFTA, see Laura Ritchie Dawson (ed), *Whose Rights? The NAFTA Chapter 11 Debate* (2002). On transatlantic economic disputes including investment disputes, see Ernst-Ulrich Petersmann and Mark A Pollack, *Transatlantic Economic Disputes: the EU, the US and the WTO* (2003).

Section 9: explores how FDI is regulated under Ch 11 of the NAFTA including its significance for Australian investors.

Section 10: examines the AUSFTA.

Section 11: 'A Prism into our Future' explores how FDI can provide new opportunities for foreign direct investors in Australia and for Australians abroad in light of the challenges that global FDI poses for our domestic legal, social, economic and political system.

A specific goal is to evaluate the issues that investors in Australia and abroad should consider before engaging in trans-border investment. These include, among others, variations in the substantive laws governing such investments, the procedures by which they are applied to foreign direct investors and the legal consequences arising from their application. Importance is placed on the need to appreciate salient differences in investment treaty protocols, the distinctive manner in which state-investment tribunals have construed them in particular contexts, and how these constructions may influence investment practice in the future.

Given the fluidity of investment law, it is not possible to provide wholly certain and predictable legal responses to investment conduct. What can be provided is an understanding of key issues faced in investment planning, including by taking account of different investment treaties, and the prospect that investor practices will be treated differently in different international and domestic legal contexts.

Australia's dilemma, in particular, is to establish its economic interdependence with a global coalition of investing nations without becoming unduly dependent on foreign infrastructures and resources. Its challenge is to strengthen its domestic economy with support of foreign investment without threatening vulnerable and sensitive sectors of our economy.

## 8. The Content of Foreign Direct Investment

FDI ordinarily occurs when an entity, usually a corporation from one state (the home state), makes a physical investment in another state (the host state). Typically, such investment involves building a factory and investing in machinery, equipment and related corporate assets. FDI is distinguished from indirect foreign investments, notably, portfolio investments that constitute 'indirect' investment.<sup>9</sup>

There are three main categories of FDI:

- *Equity capital* is the value of a multinational corporation's (MNCs) investment in shares of an enterprise in a foreign country. An equity capital stake of 10% or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise, is normally considered as a threshold for the control of assets. This category includes both mergers and acquisitions and 'greenfield' investments (the creation of new facilities). Mergers and acquisitions are an important

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<sup>9</sup> See, for example, <<http://www.unctad.org>; [www.oecd.org](http://www.oecd.org)>;

<<http://www.columbia.edu/cu/libraries/indiv/business/guides/fordinv.html>; [www.doc.gov](http://www.doc.gov); [www.ita.gov](http://www.ita.gov)>;

<<http://www.worldbank.org/>>. While this article is restricted to FDI, modern day BITS often conceive of 'investor', 'investment', 'asset' and 'enterprise' sufficiently expansively to include indirect investment as well.

This highlights not only the wide expanse of foreign investment, but also introduces controversy over the questionable public benefit arising from looser forms of capital such as portfolio investment.

source of FDI for developed countries, although the relative importance varies considerably.

- *Reinvested earnings* are the MNC's share of affiliate earnings not distributed as dividends or remitted to the MNC. Such retained profits by affiliates are assumed to be reinvested in the affiliate. This can represent up to 60% of outward FDI in countries such as the United States and the United Kingdom.
- *Other capital* refers to short- or long-term borrowing and lending of funds between the MNC and the affiliate.<sup>10</sup>

The volume of global FDI has expanded geometrically in recent decades. For example, the total annual global flow of FDI rose from US\$60 billion to US\$315 billion between 1985 and 1995. FDI has also increased significantly as a share of gross domestic production (GDP) in high-income countries, from 0.5% to 1% in the 1980s to more than 5% in 2000, and then declining to 1.4% in 2003. 'While the increase in FDI inflows was less drastic in low- and middle-income countries, the percentage of FDI in GDP remained at more than 2 percent after the year 2000, indicating a slightly higher significance of FDI flows in developing countries'.<sup>11</sup>

Particularly instrumental in this growth were the sales of foreign affiliates of MNCs which exceeded the value of world trade in goods and services. In rough terms, intra-firm trade among MNCs today constitutes approximately one-third of world trade; MNC exports to non-affiliates account for another third, and one-third consists of trade among national (non-MNC) firms.<sup>12</sup>

Also accounting for this geometric increase in FDI is the growth of investment in start-up companies, such as in software production. Such investments often entail limited start-up costs and do not require extensive outlays on plant and equipment. While many often fail to produce profits, they often represent high-return investments.<sup>13</sup>

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<sup>10</sup> WTO, *Trade and Foreign Direct Investment* (9 October 1996), <[http://www.wto.org/english/news\\_e/pres96\\_e/pr057\\_e.htm](http://www.wto.org/english/news_e/pres96_e/pr057_e.htm)>.

<sup>11</sup> See Matthias Busse and Jose Luis Groizardb, *Foreign Direct Investment, Regulations, and Growth, Policy Research Working Paper* (World Bank, 1 April 2006), <[http://www.econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000016406\\_20060414121859](http://www.econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469372&piPK=64165421&menuPK=64166093&entityID=000016406_20060414121859)>. See also R Levine, N Loayza and T Beck, 'Financial Intermediation and Growth: Causality and Causes' (2000) 46 *J Monetary Econ* 31; V N Balasubramanyam, E Borensztein, J De Gregorio and J W Lee, 'How Does Foreign Investment Affect Growth?' (1998) 45 *J Int'l Econ* 115; David Landes, *The Wealth and Poverty of Nations* (1998); R Levine and D Renelt, 'A Sensitivity Analysis of Cross-Country Growth Regressions' (Sept 1992) 82 *Am Econ Rev* 942; M Salisu and D Dapsford, *Foreign Direct Investment and Growth in EP and IS Countries* (1996) 106 *Econ J* 92. On volume of increases in FDI, see, for example, *Trade and Direct Foreign Investment* (1996), <[http://www.wto.org/english/news\\_e/pres96\\_e/pr057\\_e.htm](http://www.wto.org/english/news_e/pres96_e/pr057_e.htm)>. FDI flows into developing countries have increased from a yearly average of \$10 billion in the 1970's and less than \$20 billion in the 1980's, to \$26.7 billion in 1990, \$179 billion in 1998 and \$208 billion in 1999. See further, Jeffrey P Graham and R Barry Spaulding, *Understanding Foreign Direct Investment*, (2005), <[http://www.going-global.com/articles/understanding\\_foreign\\_direct\\_investment.htm](http://www.going-global.com/articles/understanding_foreign_direct_investment.htm)>.

<sup>12</sup> See, for example, *Trade and Direct Foreign Investment*, 9 October 1996 <[http://www.wto.org/english/news\\_e/pres96\\_e/pr057\\_e.htm](http://www.wto.org/english/news_e/pres96_e/pr057_e.htm)>

<sup>13</sup> On the development of FDI including in relation to startups, see, for example, Mary Jo Nicholson, *Legal Aspects of International Business* (2007) 332.

The scope of FDI has also expanded in recent decades to include the acquisition of a continuing management interest in a corporation or enterprise outside the investing corporation's home state. Such 'direct' investment may include a corporation directly acquiring a foreign corporation, constructing a facility, making an investment in a joint venture, or forming a strategic alliance with a local corporation such as through the licensing of technology and intellectual property.

The key to liberalisation of FDI is the cautious readiness of many countries to encourage it in order to expand their own domestic economies. Typically supporting such developments are reductions in trade tariffs and duties, and developments in communication and technology.<sup>14</sup>

FDI has also gained from liberalised domestic, regional and global trade policies, reductions in tariff barriers, loosened restrictions on both foreign investment and acquisition, and the deregulation and privatisation of industries across the globe. The results include innovations in regulatory frameworks governing investment in enterprises and capital markets, leading to ever larger, more diverse investment structures and operations. FDI has evolved further in response to new technologies, advances in global communication and developments in the management of foreign investment.<sup>15</sup>

FDI includes in particular joint ventures; that is, when parties based in different home countries engage in joint enterprises in one or the other home countries and/or in third jurisdictions. Joint ventures are frequently employed to capitalise investments, to acquire know-how in conducting the venture, such as specialised skills and products, as well as to gain access to foreign markets. Joint ventures may include a combination of investment options discussed above, such as 'Greenfield' investments, as well as mergers and acquisitions.

Global mergers and acquisitions are another important source of FDI.<sup>16</sup> Cross-border acquisitions arise when the control of assets and operations are transferred from local to foreign entities, or vice versa. In effect, local entities become affiliates of foreign entities or the converse. The benefits of mergers and acquisitions include profits from expanding productivity in foreign markets, reduced production and supply costs and increased operational efficiencies. The perceived pitfall of mergers and acquisitions arises when domestic entities cannot compete effectively against merged or acquired entities, and when foreign investors channel profits from mergers offshore.

FDI also includes a growing variety of investment opportunities, such as licensing and technology transfers, reciprocal distributorship agreements and international portfolio management.

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<sup>14</sup> On Australia's policy of liberalising FDI as a measure of Asia Pacific Economic Cooperation (APEC), see, for example, *Asia Pacific Economic Cooperation (APEC)* (2009), <[http://www.firb.gov.au/content/international\\_investment/apec.asp](http://www.firb.gov.au/content/international_investment/apec.asp)>.

<sup>15</sup> See *Going Global* (2009), <[http://www.going-global.com/articles/understanding\\_foreign\\_direct\\_investment.htm](http://www.going-global.com/articles/understanding_foreign_direct_investment.htm)>.

<sup>16</sup> Until around 1997, mergers and acquisitions constituted almost 90% of the FDI flow into the United States. Significantly derived from mergers and acquisitions and the internationalisation of production, FDI into developed countries last year rose from \$481 billion in 1997 to \$636 billion in 1998 (source: UNCTAD).

'Greenfield' investments are another significant part of FDI.<sup>17</sup> They consist of direct investments in new facilities, or acquiring existing ones. They are used to promote research and development in host countries and to facilitate linkages to global investment markets. Greenfield investments can reduce the market share of domestic competitors that cannot operate efficiently or produce inferior quality products or services. The profits from Greenfield investments may also be channelled away from host countries to investor home countries. However, such risks are endemic to FDI generally.<sup>18</sup>

FDI does not in itself ensure economic growth. In fact, economic studies suggest that, as far as developing countries are concerned, FDI has not accounted for accelerated economic growth. However, it is equally true that FDI *can* promote growth; much will depend on the state in issue, the nature of FDI and the manner of its use and regulations imposed on it, not limited to taxes and duties.<sup>19</sup>

FDI may, but need not, benefit foreign investors. Particular benefits may include:

- avoiding foreign government pressure for local production;
- circumventing trade barriers, hidden and otherwise;
- making the move from domestic export sales to a locally-based national sales office;
- capability to increase total production capacity;
- opportunities for co-production, joint ventures with local partners, joint marketing arrangements, licensing, etc.<sup>20</sup>

FDI decisions are not easily reached. Any determination to invest in a foreign market necessarily requires some consideration of the following factors:

- an assessment of actual and available resources;
- the nature of investment competition;
- an analysis of market competitiveness; and
- a synthesis of market expectations.

FDI is unlikely to grow geometrically in the immediate future, as it did in the past two decades, given the global financial crisis that has arisen since then. Preliminary data suggests a reduction in total FDI of more than 20% in 2008, with European countries being particularly vulnerable. FDI is further forecast to drop even further in 2009.<sup>21</sup>

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<sup>17</sup> A 'greenfield' investment constitutes a direct investment in new facilities or the expansion of an existing facility, also referred to as 'in-sourcing'

<sup>18</sup> See, for example, Jeffrey P Graham and R Barry Spaulding, *supra* n 11. See generally Mary Imiti and Katharine Wakelin, 'Investment Liberalization and International Trade' (2003) 61(1) *J Int'l Econ*; J R Markusen, *Trade Versus Investment Liberalization* (October 1997), <<http://www.nber.org/papers/W6231.pdf>>.

<sup>19</sup> See Jeffrey P Graham and R Barry Spaulding, *supra* n 11.

<sup>20</sup> *Ibid.*

<sup>21</sup> Reductions in Europe are: Britain down 51%; Germany down 49%; and Italy down 94%. FDI in Singapore dropped 57%, while the United States dropped only 6%. Russia (18%), China (11%) and Brazil (21%) gained.

Finally, in a global environment in which negative economic growth is predicted, FDI may well become part of the solution, as much as it may be part of the problem.

## 9. The State and the Foreign Investor

Countries, understandably, are cautious about permitting foreign entities to establish profitable beachheads on their soil in which capital outflows might exceed inflows. However, as much as FDI may provide them with the needed infrastructure and capability to develop economically, FDI may also intrude on domestic economies, threatening local investors and domestic interests.<sup>22</sup> As a result, countries are often deliberative in protecting local industries from foreign competition and in dissuading FDI that infringes on domestic public policy. Their justification in regulating FDI may lie in their exercise of sovereign power. Their means may lie in resort to trade and investment legislation, administrative regulations and procedures governing FDI. Just as countries have liberalised FDI beyond narrow customary grounds based on their 'essential security interests',<sup>23</sup> they have invented new ways of regulating it. Just as they have identified institutions and established procedures to protect the substantive and procedural rights of investors, they have established regulatory regimes to circumscribe the due process claims of foreign investors in the domestic interest.

Historic resistance to FDI has emanated from developing countries. Their rationale has been that FDI represents economic exploitation by investors from developed countries, notably MNCs. Their *modus operandi* has been to insist that, however beneficial FDI might be to their GDPs in the short term, erecting barriers selectively to FDI renders them more self-reliant economically, more self-confident culturally and more self-sufficient politically. They have expressed their resistance through such multilateral entities as the WTO. At the same time, they have concluded FTAs and BITS selectively with other countries, including developed countries, on strategic political and economic grounds.<sup>24</sup>

The ambivalence of countries towards liberalisation of FDI now also includes developed countries. In decades past, a primary preoccupation of developed countries was to find new homes abroad for their emerging investment capital. Today, investment exporters have become investment importers, and global exporters of investment like the United States have

See UNCTAD, 'Global Foreign Direct Investment Now in Decline — and Estimated to Have Fallen During 2008', (Press Release, 19 January 2009),

<http://www.unctad.org/Templates/webflyer.asp?docid=10930&intItemID=1528&lang=1>.

<sup>22</sup> On the compliance responsibilities of developing states arising from globalism and regionalism, see, Yong-Shik Lee, *Reclaiming Development in the World Trading System* (2006). See too, Luis Abugattas Majluf, *Swimming in the Spaghetti Bowl: Challenges for Developing Countries under the 'New Regionalism'*, Policy Issues in International Trade and Commodities Study Series No 27, United National Conference on Trade and Development (2004), [http://www.scholar.google.com/scholar?hl=en&lr=&q=cache:0Q1J0qun6XcJ:www.unctad.org/en/docs/itcctab28\\_en.pdf+>](http://www.scholar.google.com/scholar?hl=en&lr=&q=cache:0Q1J0qun6XcJ:www.unctad.org/en/docs/itcctab28_en.pdf+>).

<sup>23</sup> On this narrow plea of 'necessity' that states are entitled to assert as a basis for a 'taking' under customary international law, see Jürgen Kurtz, *Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis* (Jean Monnet Working Paper, June 2008) 28–31, <http://www.jeanmonnetprogram.org/papers/08/080601.html>. See further *infra* s 8.

<sup>24</sup> See generally, Andrew T Guzman, 'Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties' (1998) 38 *VA J INT'L L* 639; Susan D Frank, 'The Nature and Enforcement of Investor Rights under Investment Treaties: Do Investment Treaties Have a Bright Future?' (1992) 12 *U C Davis J Int'l & Pol'y* 47.

become destinations of investment from Europe, Japan and China.<sup>25</sup> Once the bastion of liberalised trade and investment, developed countries increasingly place an armoury of restrictions around FDI. Notably among these are limits the United States has placed on the free inflow of investment capital, such as in regulating sovereign wealth funds (SWFs).<sup>26</sup> Such restrictions on FDI are likely to grow as developed and developing countries alike attempt to limit their exposure to financial and related investment risks worldwide.

In a post-modern world in which FDI has grown perceptibly more complex, countries generally have devised ever more creative barriers to protect their home-grown industries from foreign investors.<sup>27</sup> Coupled with these developments has been an identifiable shift from old to new investment wealth in the East seeking access to previously unchartered investment waters in the West.<sup>28</sup> A further development has been the recognition that FDI is a means towards enhancing economic and political relationships with developing countries, and is in the interests of those developing countries including Australia.<sup>29</sup> A more recent and complicating phenomenon is the appreciation by host countries that innovations in regulating trade and investment, including regulating shifts of capital, represent important means of addressing the current global economic crisis.<sup>30</sup>

## 10. Regulating Foreign Investment: Australia's Experience

In theory, the liberalisation of FDI should not only benefit foreign investors. It should help domestic economies share in the wealth derived from foreign investment. A means of generating domestic revenue, FDI may also serve as an effective means by which to redeploy those revenues into their economic, social and political infrastructures. Insofar as countries restrict FDI in protected sectors, they may encourage it in less protected sectors. In regulating FDI strategically in the short term, they may also stabilise its economic impact in the longer term, including for the benefit of foreign investors. For example, Australia maintains certain restrictions, including limits on equity participation, in a few areas in which foreign investment is thought to generate community concern. Australia maintains equity restrictions which virtually exclude foreign ownership of Telstra, CSL, Qantas and other Australian international airlines, federal leased airports and shipping. Australia also requires that all

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<sup>25</sup> On China's foreign policy in relation to international investment, see Yong Deng and Fei-Ling, *China Rising: Power and Motivation in Chinese Foreign Policy* (2005). On foreign investment in the United States, see, for example, Mack Ott, 'Foreign Investment in the United States' in *The Concise Encyclopaedia of Economics* (The Library of Economics and Liberty, 2002), <<http://www.econlib.org/Library/Enc/ForeignInvestmentintheUnitedStates.html>>.

<sup>26</sup> See, for example, Aaditya Mattoo and Arvind Subramanian, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization* (Working Paper Series 08/02, Peterson Institute, January 2008), at <<http://www.petersoninstitute.org/publications/wp/wp08-2.pdf>>; Ronald J Gilson and Curtis J Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, Stanford Law and Economics Olin Working Paper No 355; Columbia Law and Economics Working Paper No 328 (18 February 2008), <[http://www.papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1095023](http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1095023)>.

<sup>27</sup> On the impact of national security concerns upon the regulation of FDI by the United States Government, see, for example, Edward M Graham and David M Marchick, *US National Security and Foreign Investment* (2006).

<sup>28</sup> See, for example, Gerald Chan, *China's Compliance in Global Affairs: Trade, Arms Control, Environmental Protection, Human Rights* (2006); Yong Deng and Fei-Ling, *supra* n 25.

<sup>29</sup> See esp. *Investment for Development*, at <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>30</sup> For recent books exploring the principles underlying international investment law and the tensions between that law, state sovereignty and international investment practice, see Rudolph Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2008); Philippe Kahn and Thomas W Walde (eds), *New Aspects of International Investment Law* (2007); Peter Muchlinski, Federico Ortino and Christoph Schreuer, *Oxford Handbook on International Investment Law* (2008).

foreign direct investment and all portfolio foreign investment of 5% or more in the media sector require prior approval. These restrictions are not affected by Australian BITs and FTAs, including the much discussed AUSFTA.

Like many of its trading partners, Australia has actively encouraged foreign investment, while at the same time remaining interested in regulating the foreign ownership of Australian assets. In this regard, Australia retains the right to examine significant foreign investment proposals in all sectors to ensure they do not raise issues contrary to the national interest. Australia accomplishes this primarily through the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (FATA), together with associated regulations and policy, and certain sector or company specific legislation.<sup>31</sup> The Foreign Investment Review Board (FIRB) administers the FATA and advises the Treasurer on foreign investment policy. The FIRB generally receives between 4,500 and 6,000 proposals for foreign investment approval annually.<sup>32</sup>

The FATA applies to share and asset acquisitions, investment in urban land, and agreements relating to the operation or control of Australian businesses. In every case, the FATA sets out a number of qualifications and procedures relating to foreign investment in Australia. For example, proposals from foreigners to make a Greenfield investment, where the value of the company's assets is A\$10 million or more, are not covered by the Act. However, they still must be notified to the Treasurer. The FATA requires that foreign investors notify the Treasurer, through the FIRB, of certain acquisitions of interests in Australian corporations and land. The FATA also empowers the Treasurer to make orders in regard to investment proposals which are deemed to be contrary to Australia's national interests. This more onerous requirement relates to, *inter alia*, certain share acquisitions whereby proposals to acquire Australian businesses must be notified to, and receive the explicit approval of, the Treasurer. For instance, proposals seeking to acquire interests of 15% or more by a single foreign entity or person and 40% or more by two or more foreign entities or persons, in Australian businesses or prescribed corporations whose assets are valued at over A\$50 million, must be notified to the Treasurer and can be rejected if considered to be contrary to the 'national interest'. In the alternative, the Treasurer can approve the proposal subject to conditions which address national interest concerns.

In regulating FDI, the Australian Government, like governments elsewhere, inevitably makes strategic choices. Those include electing among competing measures of reform, ranging from reformulating tax and monetary policy to social law reform. In seeking to attract FDI selectively, Australia may need to prioritise among domestic interests that are not always mutually compatible. For example, the Australian Government may encourage FDI to secure cheaper goods for sale in local markets, while recognising the negative impact such FDI may have on domestic employment. It may also make strategic choices, not only in deciding whether to reduce regulatory restrictions on FDI, but also when and how to do so.

In regulating FDI, governments may find themselves between a rock and a hard place. However much they may publicly declare their commitment to international standards of due process of law, they may adopt inconsistent regulatory practices. They may, not always intentionally, imbed privileged constituencies at the expense of disadvantaged ones. However attractive they may intend their laws and regulations governing FDI to be, they may

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<sup>31</sup> See, for example, *Qantas Sale Act 1992*; *Telstra Corporation Act 1991*; and *Broadcasting Services Act 1992*.

<sup>32</sup> For more information and statistics, see the website of the Foreign Investment Review Board, at <<http://www.firb.gov.au/content/default.asp>>.

subjugate FDI through selective expropriation, denying procedural or substantive justice in specific cases. In expropriating FDI on public policy grounds, they may disappoint the reasonable expectations of some foreign investors by denying protection to their legitimate property rights. In presenting FDI as ‘theft’ of national resources, they may legitimate *their* selective ‘confiscation’ of foreign investments.

Illustrating these issues for governments generally is the vagueness of ‘national interest’ criteria that some foreign investors consider arbitrary in nature. Such investor concerns are especially germane during economic downturns, in which economic nationalism increases and countries scrutinise potential takeovers and mergers most carefully. A recent example of this is the now failed Chinalco’s (a Chinese state-owned enterprise) US\$19.5 billion investment in Australian mining company Rio Tinto. At the time of researching this article, the Treasurer (Wayne Swan) was considering whether to approve the deal on grounds of ‘national interest’, although Rio’s Board ultimately withdrew its proposal on 5 June 2009.<sup>33</sup> Of note, a ‘national interest’ intervention was last invoked in 2001, when the Treasurer (Peter Costello) blocked the proposed bid by Royal Dutch Shell for Woodside Petroleum.

None of this is to suggest that the Australian Government has abused its sovereign powers in regulating FDI. However seemingly intrusive its actions may be, host governments may use tax revenues generated by FDI to build economic infrastructures that encourage the growth of FDI domestically. Far from denying foreign investors due process of law, they may act quite legitimately under international investment law.

The next section evaluates the global investment environment, notably the General Agreement on Trade and Tariffs (GATT) and the WTO. Subsequent sections consider the impact of global, regional and domestic laws upon foreign direct investment.

## **11. FDI in its International Context**

The significance of regulating FDI is best understood by reflecting on the international environment in which it takes place. It is also important to appreciate that such regulation arises from multilateral, regional and bilateral agreements, not limited to those where Australia is a party. As a practical matter, an Australian who invests abroad must also be cognisant of the domestic law of the ‘host’ country, including the prospective impact of its laws upon investments there.

Following the Second World War, a new era of liberalisation of trade and investment began, heralded by the adoption of the GATT in 1947. Its purpose was to reduce protectionist

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<sup>33</sup> See, for example, *Chinalco, Rio Deal Collapses* (9 June 2009), <<http://www.smh.com.au/business/chinalco-rio-deal-collapses-20090605-bxdc.html>>.

barriers that had preceded the War and to guide the liberalisation of trade and investment.<sup>34</sup> In practice, the treatment of FDI was largely excluded from the ambit of the GATT.<sup>35</sup>

However, the GATT contracting parties did adopt a resolution in 1955 on International Investment for Economic Development in which they ‘urged’ member countries to conclude bilateral investment agreements.<sup>36</sup> The issue of international investment was also addressed by a GATT Panel in *Canada-Administration of the Foreign Investment Review Act (FIRA)*<sup>37</sup>. The issue was not whether Canada had the right to regulate foreign investment which it clearly did. The issue was whether it had engaged in ‘trade distorting’ measures through its local content and export performance requirements, and whether such conduct violated the GATT. The panel held that Canada’s local content requirements were inconsistent with its ‘national treatment’ duties under Art III: 4 of the GATT. In contrast, it held that Canada’s export ‘performance requirements’ were not inconsistent with its GATT obligations. In so determining, the panel also confirmed the limited scope of the GATT in regulating FDI.<sup>38</sup>

### xv. The World Trade Organization

Over the latter third of the twentieth century, the WTO has evolved into a global mechanism capable of liberalising trade and investment generally.<sup>39</sup> What the GATT began as a patchwork quilt in 1947,<sup>40</sup> the WTO inherited. However, the WTO has been reluctant to liberalise international investment in a comparable manner to its liberalisation of trade. Dominated by developing countries, the WTO was opposed to any comprehensive inclusion of foreign direct investment in multilateral talks. This reluctance to liberalise international investment regulation, initially spearheaded by the USSR and its allies, was exemplified in the limited recognition of FDI in the Uruguay Round of negotiations.<sup>41</sup> It was also reflected

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<sup>34</sup> The Havana Charter was intended to serve as an impetus for the multilateral community to agree upon an international trade and investment regime. The Havana Charter, a creation of the now defunct International Trade Organization (ITO), was signed on 24 March 1948, with 53 signatory states. However, it failed to gain the support of the United States Congress and ultimately, had limited influence over international trade and investment generally. See United Nations Conference on Trade and Employment, *Final Act and Related Documents* (UN Doc E/Conf 2/78, 1948). See also A N Capling, *Australia and the Global Trade System: From Havana to Seattle* (2001); James Tanham, *The Havana Charter: Good or Bad?* (1949).

<sup>35</sup> This is despite the fact that investment was included in the Havana Charter designed to create an International Trade Organization (ITO) in the mid-1940s. However, due to resistance from the United States Congress, the ITO was never formed and the Havana Charter was abandoned. See Simon Lester and Bryan Mercurio, *World Trade Law: Text, Materials and Commentary* (2008) 633–4.

<sup>36</sup> International Investment for Economic Development Resolution, 4 Mar 1955, GATT BISD (3rd Supp) 49–50.

<sup>37</sup> BISD 30S/140, 1984.

<sup>38</sup> *Ibid.* Technical information on trade and investment is available at <[http://www.wto.org/English/tratop\\_e/invest\\_e/invest\\_info\\_e.html](http://www.wto.org/English/tratop_e/invest_e/invest_info_e.html)>.

<sup>39</sup> The WTO Dispute Settlement System was established during the Uruguay Round, but built on the foundations established by the GATT in 1947. See generally Ernst-Ulrich Petersmann, *The GATT/WTO Dispute Settlement System: International Law, International Organizations and Dispute Settlement* (1997). On regional trade and investment agreements under the GATT and WTO, see, for example, James H Mathis, *Regional Trade Agreements in the GATT/WTO: Article XXIV and the International Trade Requirement* (2002).

<sup>40</sup> The GATT 1947 Dispute Settlement System is contained in Arts XXII and XXIII. See the decision of 5 April 1996 on procedures under Art XXIII; The Understanding on Notification, Consultation, Dispute Settlement and Surveillance (28 Nov 1979) (BISD 26S/210); The Decision on Dispute Settlement, contained in Ministerial Declaration (29 Nov 1982) (BISD 29S/210); The Decision on Dispute Settlement (30 Nov 1984) (BISD 31S/9).

<sup>41</sup> On the Uruguay Round, see John H Jackson and Alan O Sykes, *Implementing the Uruguay Round* (1997), but see Graham Dunkley, *The Free Trade Adventure: The Uruguay Round and Globalism: A Critique* (1997).

in open hostility to liberalising FDI at successive ministerial WTO meetings in Singapore, Doha<sup>42</sup> and Cancun.<sup>43</sup>

The resistance of the developing world to liberalised FDI was also audible before the United Nations (UN). In 1962 the UN passed General Assembly Resolution 1803. There it formally protected the ‘permanent sovereignty of countries over natural resources and sanctioned nationalization, expropriation or requisitioning’ on ‘grounds or reasons of public utility, security or the national interest which are recognised as overriding purely individual or private interests’.<sup>44</sup> The effect of Resolution 1803 was to transform the protection of natural resources into paramount domestic public policy.<sup>45</sup>

General Assembly Resolution 1803 was followed by other steps to entrench state sovereignty over foreign investors. An otherwise obscure UN Charter of Economic Rights and Duties of States recognised the right of countries to expropriate foreign investment.<sup>46</sup> That charter is notable for its omission of uniform international standards of due process to govern ‘government takings’ and compensation. The result, again, was the UN’s affirmation of the paramount public interest of host countries in regulating foreign investments including, but not limited to, those of MNCs.<sup>47</sup>

Offsetting the pervasive resistance by the WTO to the liberalisation of international investment were two countervailing movements: the first was the selective liberalisation of FDI by the WTO; and the second was liberalisation by individual WTO members, including Australia.<sup>48</sup>

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<sup>42</sup> Multilateral investment negotiations were conducted under the auspices of the WTO in the Doha Round, but with scant results. See Doha Ministerial Declaration, Fourth Ministerial Conference in Doha, Qatar, paras 20–22 (Nov 2001), <<http://www.wto.org>>. On the ‘quiet’ resurrection of the Doha Talks through to Hong Kong, see, for example, recent comments of the US Trade Representative, Susan Schwab (23 February 2007), <<http://www.iht.com/articles/ap/2007/02/23/business/NA-FIN-US-Doha-Talks.php>>. On different WTO negotiation strategies since Doha, see <[http://www.twinside.org.sg/trade\\_1.htm](http://www.twinside.org.sg/trade_1.htm)>

<sup>43</sup> On the conflict between the collective interest of developing states in opposing multilateral negotiations on investment and the readiness of individual states to negotiate such agreements bilaterally in competition with other developing states, see *infra* s 5v. See too Andrew Guzman, *supra* n 24.

<sup>44</sup> The resolution is reproduced at <<http://www.taiwandocuments.org/un1803-XVII.htm>>.

<sup>45</sup> Resolution 1803(4) states: ‘Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law ...’. Resolution 1803(7) adds: ‘Violation of the rights of peoples and nations to sovereignty over their natural wealth and resources is contrary to the spirit and principles of the Charter of the United Nations and hinders the development of international co-operation and the maintenance of peace’. See further <[http://www.unhchr.ch/html/menu3/b/c\\_natres.html](http://www.unhchr.ch/html/menu3/b/c_natres.html)>.

<sup>46</sup> See United Nations General Assembly, Charter of Economic Rights and Duties of States, GA Res 3281 (XXIX), UN GAOR, 29th Session, 2315th Plen Mtg, UN Doc A/RES/3281 (XXIX) (12 December 1974), reprinted in (1975) 14 *ILM* 251.

<sup>47</sup> See Charles N Brower and John Tepe, Jr, ‘The Charter of Economic Rights and Duties of States: A Reflection or a Rejection of International Law?’ (1975) 9 *Int’l Law* 295; Burns Weston, ‘The Charter of Economic Rights and Duties of States and the Deprivation of Foreign Owned Wealth’ (1981) 75 *Am J Int’l L* 437.

<sup>48</sup> On Australia’s involvement in such liberalisation in the wake of the DOHA Round Negotiations, see <<http://www.dfat.gov.au/trade/negotiations/index.html>>.

### **xvi. Selective Liberalisation**

Foreign investment was discussed in the Uruguay Round of trade talks which led to the creation of the WTO. The result was a very limited agreement, the Agreement on Trade-Related Investment Measures (the TRIMs Agreement) which essentially merely interprets and clarifies the GATT provisions on 'national treatment' for imported goods (Art III) and on quantitative restrictions on imports or exports (Art XI) as they relate to investment measures. In other words, the TRIMs Agreement merely prohibits specific trade-distorting performance requirements on foreign direct investments, but does not directly regulate nor harmonise the regulation of foreign investment. The Agreement, therefore, has a limited focus which relates merely to existing GATT disciplines on trade in goods. It does not regulate foreign investment *per se* and it does not address measures such as local equity requirements, technology transfer and licensing requirements, local manufacturing requirements, personnel entry restrictions and local employment requirements. As a result, the scope of the Agreement focuses on trade in goods as distinct from FDI.<sup>49</sup> Three further international agreements relating to investment were concluded. The General Agreement on Trade Related Services (GATS) deals with trade-related services including, among others, investment services. The Agreement on Trade Related Intellectual Property Rights (TRIPs) imposes duties on countries to protect intellectual property rights including in relation to FDI. Finally, the Agreement on Subsidies and Countervailing Measures (SMT) regulates government-conferred benefits and includes selected prohibitions and actionable remedies.<sup>50</sup>

### **xvii. Bilateral Investment Agreements**

Developing countries that collectively resisted liberalised international investment through the WTO and UN sometimes pursue selected trade and investment partnerships including with developed countries. Eastern European countries that ardently resisted FDI as capitalist exploitation prior to the Cold War increasingly endorse BITs and FTAs to prop up their fragile economies.<sup>51</sup> China's ideological opposition to FDI historically has mutated into an affirmation of FDI, albeit strictly regulated on national interest grounds.<sup>52</sup>

This selective liberalisation of FDI has been far from seamless. An unavoidable tension has evolved between the common interests of WTO member countries not to liberalise FDI and their individual interests to conclude BITs with developed countries and FTAs selectively with one another. As a result, developing countries have had to weigh their need to maintain their fealty to the WTO, while pursuing strategic investment treaties with countries like the United States and the European Union (EU). An uncomfortable consequence has been that some of the same developing countries that have block voted against FDI in multilateral

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<sup>49</sup> The TRIMs Agreement is available at <[http://www.wto.org/english/docs\\_e/legal\\_e/18-trims.pdf](http://www.wto.org/english/docs_e/legal_e/18-trims.pdf)>.

<sup>50</sup> On the TRIPs Agreement, see *Resource Book on TRIPS and Development* (2005). The SMT Agreement is available at <<http://www.worldtradelaw.net/uragreements/scmagreement.pdf>>.

<sup>51</sup> On BITs with developing countries, see <[http://www.iisd.org/pdf/2008/dci\\_recent\\_dev\\_bits.pdf](http://www.iisd.org/pdf/2008/dci_recent_dev_bits.pdf)>.

<sup>52</sup> On China's involvement in international investment, see generally, *China and the WTO*, <[http://www.wto.org/english/thewto\\_e/countries\\_e/china\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/china_e.htm)>; for further sites, see <<http://www.china.org.cn>>; <<http://www.chinatoday.com>>; <<http://www.china-window.com>>; <<http://www.thechinabusinessnetwork.com>>. See also 12th China Fair for Investment and Trade, <<http://www.chinafair.org.cn/english/index/index.aspx>>.

forums have concluded a spattering of regional and bilateral investment agreements that favour FDI.<sup>53</sup>

Developing countries that support FDI in this manner have taken calculated risks. In presenting themselves to prospective investment partners as economically sustainable, they sometimes have had to build expensive social and economic infrastructures which they can ill afford.<sup>54</sup> In posturing as being politically stable in order to attract FDI, some of these countries have repressed political dissent<sup>55</sup> and distributed the benefits of FDI inequitably to appease powerful local interests.<sup>56</sup>

Nor is such ambivalence towards the liberalisation of FDI limited to developing countries. Developed countries that historically proclaimed their commitment to liberalisation have increasingly faced pressure from domestic interests to regulate FDI. These pressures have grown as investment inflows have exceeded investment outflows and as domestic investors have lost their competitive advantage to foreign investors.<sup>57</sup>

The result has sometimes been to dislocate, rather than stabilise, the balance between liberalised and regulated FDI. Developed countries, on occasions, have tacitly supported regulatory abuses by developing countries, including human rights violations, due to their pervasive interest in securing attractive beachheads for their investors in those developing countries. The result, all too often, has been the tendency of developing countries to accentuate rather than temper the inequitable distribution of resources that FDI is sometimes supposed to address.<sup>58</sup>

Further impeding the progressive pathway of FDI have been continual changes in the conception of FDI. Once restricted to the direct investments of MNCs, FDI has expanded to include an array of foreign investors and investments not limited to those of subsidiaries, affiliates and other strategic partners of MNCs. These developments have not only widened the category of 'foreign investor', but have complicated the regulation of increasingly diverse FDI practices.<sup>59</sup> The role of MNCs in international investment, among others, has contributed to a series of non-binding Guidelines for Multinational Enterprises under the auspices of the

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<sup>53</sup> On the evolving influence of developing states over international trade and investment, see, for example, Bernard Hoekman and Will Martin, *Developing Countries and the WTO: A Pro-active Agenda* (2005).

<sup>54</sup> On these issues facing developing states, see, for example, H S Kehal (ed), *Foreign Investment in Developing Countries* (2004); John M Rothgeb, Jr, *Foreign Investment and Political Conflict in Developing Countries* (1995).

<sup>55</sup> See, for example, Robin Broad, *Global Backlash: Citizen Initiatives for a Just World Economy* (2002). But see Kent Albert Jones, *Who's Afraid of the WTO?* (2003); Benjamin Heim Shepard and Ronald Hayduk, *From Act up to the WTO: Urban Protest and Community Building in an Era of Globalization* (2002).

<sup>56</sup> See, for example, Caroline Dommen, 'Raising Human Rights Concerns in the World Trade Organization — Actors, Processes and Possible Strategies' (2002) 24 *Human Rights Quarterly* 1; John Hilary, *The Wrong Model: GATS, Trade Liberalization and Children's Right to Health* (2000).

<sup>57</sup> On the shift towards investment protectionism in the United States, for example, see *infra* s 8iii.

<sup>58</sup> Typical but often costly means of attracting foreign investment is for developing states to build their IT infrastructures. See, for example, Sam Lubbe, *IT Investment in Developing Countries: an Assessment and Practical Guide* (1999). Other concessions relate to environmental standards. See, for example, Christoph Böhringer and Andreas Löschel, 'Climate Policy-Induced Investments in Developing Countries: The Implications of Investment Risks' (2008) 31(3) *The World Economy* 367.

<sup>59</sup> On the growing diversity of FDI, see *supra* s 1.

Organisation for Economic Cooperation and Development (OECD) in respect of which Australia is both a signatory and an active participant.<sup>60</sup>

### xviii. Treaties of Friendship, Commerce and Navigation

A pre- and early post-World War II incantation of the liberalisation of international investment was the development of various FCNTs. In the post-war era, countries used FCNTs in part to protect their investors operating in foreign markets under the umbrella of the GATT.<sup>61</sup> The underpinnings of FCNTs lay in the dual bulwarks of investment equality, notably in ‘most favoured nation treatment’ or ‘national treatment’ accorded to investors from foreign countries.<sup>62</sup>

FCNTs also provided for dispute resolution. Ordinarily investors were required to first exhaust local remedies in the courts of the host country. However, after having done so, provision was made for the submission of disputes to the International Court of Justice (ICJ) with the consent of the host country.<sup>63</sup>

FCNTs reflected the interest of investors from developed countries; they were firmly resisted by the USSR and its allies as illustrations of exploitive capitalism.<sup>64</sup> FCNTs were also undermined by the passing of the UN General Assembly’s Declaration of the New International Economic Order in 1974 which recognised state sovereignty over natural resources and other economic activities.<sup>65</sup> The result was reflected in the comparative brief span of influence of FCNTs, as well as in the failed quest to reach agreement on a multilateral investment treaty.<sup>66</sup>

### xix. BITs and FTAs

FCNTs overlapped in part with the early development of modern BITs. Starting in 1959 with an investment agreement between West Germany and Pakistan,<sup>67</sup> BITs have grown steadily into a substitute for global agreement on FDI, which the WTO and UN were unwilling to

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<sup>60</sup> On Australia’s participation in the implementation of these non-binding guidelines, see, for example, <<http://www.ausncp.gov.au/>>. On the OECD and FDI, see, Organization for Economic Cooperation and Development, *International Investment Law: Understanding Concepts and Tracking Innovations A Companion Volume to International Investment Perspectives* (2008).

<sup>61</sup> On the GATT, see, for example, Calvin A Hamilton and Paula I Rochwerger, ‘Trade and Investment: Foreign Direct Investment through Bilateral and Multilateral Treaties’ (2005) 18 *NY Int’l L Rev* 1, 4.

<sup>62</sup> On most-favoured-nation treatment, see Yas Banifatemi, ‘The Emerging Jurisprudence on the Most-Favoured-Nation Treatment in Investment Arbitration’ in A Bjorklunk, I Laird and S Ripinsky (eds), *Investment Treaty Law: Current Issues III* (2008). On national treatment, see Gaetan Verhoosel, *National Treatment and WTO Dispute Settlement* (2002); Marus Krejowski, *National Regulation and Trade Liberalization in Services* (2003).

<sup>63</sup> The author is unaware of any decision by the ICJ as a result of a submission under a FCNT. But see *infra* n 93 on provision for referral of ICSID disputes to the ICJ.

<sup>64</sup> See *supra* s 5iii.

<sup>65</sup> United Nations General Assembly, Charter of Economic Rights and Duties of States, GA Res 3281 (XXIX), UN GAOR, 29th Session, 2315th Plen Mtg, UN Doc A/RES/3281 (XXIX) (12 December 1974), reprinted in 14 *ILM* 251 (1975). See also Charles N Brower and John Tepe, Jr, *supra* n 47; Burns Weston, ‘The Charter of Economic Rights and Duties of States and the Deprivation of Foreign Owned Wealth’ (1981) 75 *Am J Int’l L* 437.

<sup>66</sup> See, for example, Riyaz Dattu, ‘A Journey from Havana to Paris: The Fifty-Year Quest for the Elusive MAI’ (2000) 24 *Fordham Int’l LJ* 295.

<sup>67</sup> On this agreement, see Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties I* (1995).

deliver. Today, there are close to 3,000 BITs and FTAs, mostly concluded in the past two decades.<sup>68</sup>

Countries diverge in choosing between BITs and FTAs. For example, the United States initially sought to build a free market for American trade and investment abroad through FTAs. Its most important FTA, the NAFTA with Canada and Mexico, eventuated in the early 1990s.<sup>69</sup> The United States only actively began to conclude BITs globally in 1998.<sup>70</sup>

The primary purpose of BITs was to undermine the discriminatory practices of partner countries in relation to foreign investment. The subsidiary goal was to carve principles, standards and rules by which to regulate foreign investment consistent with these features. Key features include applying either national or most-favoured nation treatment to foreign investment, depending on which better protects the investor. Provision is often made for standards to govern the expropriation of investments and the payment of prompt, fair and reasonable compensation. Further reference is usually made for the transfer of funds for investment purposes at reasonable exchange rates. In addition, a small number of BITs contain provisions on the movement of certain employees. In general, most BITs and FTAs covering investment apply to all sectors, with any exempted sectors expressly stated in the agreement.<sup>71</sup>

BITs and FTAs are distinguishable from one another in their variety, the uneven economic and political clout of the parties to them, the variable manner in which they define 'investor', 'investment', 'asset' and 'enterprise', as well as the different standards of treatment they accord to foreign 'investors' and 'investments'. BITs and FTAs also use different mechanisms to resolve international investment disputes. The United Nations Conference on Trade and Development (UNCTAD) provides the following definition of BITs:

Bilateral investment treaties (BITs) are agreements between two countries for the reciprocal encouragement, promotion and protection of investments in each other's territories by companies based in either country. Treaties typically cover the following areas: scope and definition of investment, admission and establishment, national treatment, most-favoured-nation treatment, fair and equitable treatment, compensation in the event of expropriation or damage to the investment, guarantees of free transfers of funds, and dispute settlement mechanisms, both state-state and investor-state.<sup>72</sup>

The earliest BITs were concluded principally between developed Western countries, offsetting in part the collective economic and political will of developing countries over the multilateral trade

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<sup>68</sup> On the plethora of bilateral investment agreements, see <<http://www.unctadxi.org/templates/DocSearch.aspx?id=779>>.

<sup>69</sup> See, for example, US Bilateral Investment Treaty Program, State Department, fact sheet, 16 March 2005, <<http://www.state.gov/e/eb/rls/fs/22422.htmf>>. On the growth and significance of international arbitration generally, see Leon E Trakman, 'Arbitrating Options: Turning a Morass into a Panacea' (2008) 31 *UNSW Law Journal*; Leon E Trakman, 'The Proliferation of Free Trade Agreements: Bane or Beauty?' (2008) 42 *J Int'l Trade* 367.

<sup>70</sup> *Ibid.* See Kenneth J Vandavelde, 'The Bilateral Treaty Program of the United States' (2001) 21 *Cornell Int'l LJ* (that there were only 75 BITs in 1968. During the 70's, nine BITs were negotiated each year; that rate doubled in the 80's and has been increasingly geometrically ever since then: at 172). See also, *Research Note: Recent Developments in International Investment Agreements*, United Nations Conference on Trade and Development (30 Aug 2005) (UNCTAD), <<http://www.unctad.org>>.

<sup>71</sup> See generally Vandavelde, *ibid* n 70.

<sup>72</sup> UNCTAD, *What are BITs?*, 17 August 2004, <[http://www.unctadxi.org/templates/Page\\_\\_\\_1006.aspx](http://www.unctadxi.org/templates/Page___1006.aspx)>. See generally <<http://www.unctadxi.org/templates/DocSearch.aspx?id=779>> .

and investment system. Modern BITs are far more widespread, including both developed and developing countries. Key principles contained within BITs as a class include applying national or most-favoured nation treatment to foreign investment; setting out standards to govern the expropriation of investments and the payment of adequate compensation; and providing for the transfer of funds for investment at reasonable exchange rates. BITs also delineate ‘performance requirements’ that host countries can impose on foreign investors, such as prohibiting the requirement that foreign investors hire domestically.<sup>73</sup>

State partners to various BITs generally agree to limits on the ‘performance requirements’ they can impose on foreign investors. They are usually prohibited from imposing requirements that investors hire local nationals; and from prohibiting foreign investors from submitting disputes to arbitration as distinct from domestic courts of law in pursuing fair and equitable treatment. The inclusion of commercial arbitration is noteworthy, and a shift from the general treaties of friendship grounded in diplomacy (which often included the submission of disputes to the ICJ), to investment agreements that provide both distinct processes to government investment and applicable remedies.<sup>74</sup>

BITs provide two primary mechanisms for the resolution of investor-state disputes. The first and more common mechanism is through investment. The second and less frequent recourse is that state parties submit investor disputes to the domestic courts of host countries.<sup>75</sup> State-investor arbitration is adopted, variously, because it is devised specifically to resolve investment disputes; it usually functions under the rules and procedures of established institutions like the ICSID or UNCITRAL Rules, and is applied by tribunals that are considered expert on FDI.<sup>76</sup> A few BITs, including between developed countries like the United States and Australia, refer disputes to domestic courts on the ground of confidence in each other’s judicial systems, or less overtly, due to reluctance to submit investor-state disputes to tribunals that are not accountable to domestic courts.<sup>77</sup>

Pervasive provisions in BITs and FTAs relate to expropriation, including the requirement that signatory parties: agree not to expropriate FDI so long as the measures are non-discriminatory; apply them for a public purpose; accord host investors with due process of law; and make payment of prompt, fair and adequate compensation in consequence of a legitimate ‘taking’.<sup>78</sup>

BITs and FTAs diverge significantly in their manner of regulating FDI. Reflecting a variable body of international norms, they impose different standards of compliance on investors and

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<sup>73</sup> See Kenneth Vandeveld, ‘A Brief History of International Investment Agreements’ (2005) 12 *UC Davis J Int’l L & Pol’y* 157; Calvin A Hamilton and Paula I Rochwerger, *supra* n 61; Andrew T Guzman, *supra* n 24. See too Carlos Garcia, ‘All the Dirty Little Secrets: Investment Treaties, Latin America and the Necessary Evil of Investor-State Arbitration’ (2004) 16 *Fla Int’l LJ* 301.

<sup>74</sup> See, for example, Leon E Trakman, *supra* n 69; Christoph Schreuer, ‘Fair and Equitable Treatment in Arbitral Practice’ (2005) 6 *Journal of World Investment & Trade* 357.

<sup>75</sup> On these mechanisms under the AUSFTA, see *infra* s 10.

<sup>76</sup> On the predisposition favouring investor-state arbitration, see *infra* s 6ii

<sup>77</sup> On these issues in relation to the US-Australia Free Trade Agreement, see Thomas Westcott, *Foreign Investment Issues in the Australia-United States Free Trade Agreement*,

<[http://www.treasury.gov.au/documents/958/pdf/06\\_foreign\\_investment\\_policy\\_ausfta.pdf](http://www.treasury.gov.au/documents/958/pdf/06_foreign_investment_policy_ausfta.pdf)>.

<sup>78</sup> See generally Vandeveld, *supra* n 73. See also Investment Promotion and Protection Treaties (ICSID, 1983).

grant dissimilar concessions. They also offer uneven guidance on the permissible nature and limits of a ‘government taking’.<sup>79</sup>

BITs and FTAs also provide different formulae and mechanisms for resolving investor-state disputes. Those BITs and FTAs that stipulate for investor-state disputes to be resolved by investment tribunals ordinarily rely on, to varying degrees, the ICSID, ICSID Additional Facility or UNCITRAL Rules. These mechanisms providing for investor-state dispute resolution are distinctive in two important respects. First, they diverge from customary international law by which countries, not private investors, are parties to international investment disputes. Second, they have produced a growing *ad hoc* jurisprudence on investment law that, while lacking the binding force of common law precedent, has added to the international *opinio juris* on investment law.<sup>80</sup>

Some BITs are also adhesive in nature. In effect, they are presented by developed to developing countries as a *faite accompli* for formal endorsement and concluded in the absence of meaningful bargaining over the terms, including over investor-state mechanisms governing dispute resolution.<sup>81</sup>

Despite these controversies, the number and variety of BITs and FTAs has grown geometrically; they have also extended their economic and political stature.<sup>82</sup> BITs have become particularly influential in regulating investment disputes.<sup>83</sup> Some try to accommodate the fact that party countries are unequal in their economic and political power. More recent BITs sometimes include sovereignty enhancing features, notably in those concluded by the United States and European countries such as Norway.<sup>84</sup>

The lack of systematic treatment of BITs and FTAs may nevertheless lead to uncertainty over how investment tribunals and courts might apply them. Confusion is likely to arise over differences among dispute resolution mechanisms in BITs and FTAs that refer investment disputes to domestic courts. Further confusion also may occur over the manner in which investment tribunals might construe BITs and FTAs in which investment arbitration is the preferred recourse. Differences are also likely to eventuate over how domestic courts charged with jurisdiction, such as under the AUSFTA, might construe specific provisions that are peculiar to the BIT under examination, compared to how other courts as well as investment tribunals might construe comparable or similar provisions under other investment treaties.<sup>85</sup>

In concluding BITs, countries do not necessarily receive what they intend. On occasions, they may conclude BITs and FTAs that give greater strategic advantage to partner countries and

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<sup>79</sup> On the difference between dispute resolution under customary international law and modern BITs, see Jürgen Kurtz, *supra* n 23, pp 28–31. On the limits associated with *ad hoc* state-investor decision-making, see *infra* s 6ii.

<sup>80</sup> See, for example, Jürgen Kurtz, *supra* n 23.

<sup>81</sup> On BITs and developing states, see <[http://www.iisd.org/pdf/2008/dci\\_recent\\_dev\\_bits.pdf](http://www.iisd.org/pdf/2008/dci_recent_dev_bits.pdf)>. See also Andrew J Guzman, *supra* n 24.

<sup>82</sup> Vandevelde writes that in 1969 there were only 75 BITs. During the 70’s, nine BITs were negotiated each year; that rate doubled in the 80’s and has been increasingly geometrically ever since then. See Vandevelde, *supra* n 73, at 172. See also *Research Note: Recent Developments in International Investment Agreements, United Nations Conference on Trade and Development* (UNCTAD, 30 Aug 2005), <<http://www.unctad.org>>.

<sup>83</sup> See Leon E Trakman, ‘The Proliferation of Free Trade Agreements’, *supra* n 69; Rudolf Dolzer and Magrete Stevens, *supra* n 67; Kenneth J Vandevelde, *supra* n 70.

<sup>84</sup> On these developments, see <<http://www.regjeringen.no/en/dep/ud/Documents/NOU-er/2008/nou-2008-14-2/7/4.html?id=538431>>. See also, Andrew Newcombe, ‘Canada’s New Model Foreign Investment Protection Agreement’ (Fall, 2004) 30 (14) *Bulletin, Canadian Council of International Law*, <[http://www.ccil-ccdi.ca/index.php?option=com\\_content&task=view&id=89&Itemid=86](http://www.ccil-ccdi.ca/index.php?option=com_content&task=view&id=89&Itemid=86)>.

<sup>85</sup> See further *infra* s 5.

investors than to themselves and their own investors, a concern that might be attributed to the AUSFTA. They may also select strategies, such as protecting sensitive sectors of the domestic economy, to regulate FDI that lead to conflict. Such eventualities, including the risk of making strategic miscalculations, are implicit in any process of negotiation. They are calculated hazards that governments like the Australian Government take when concluding investment agreements both with immediate neighbours as well as with more distant state partners. They are calculated risks that countries take based on a perceived political, economic and social benefit at the time, but which with the benefit of hindsight, may prove to be faulty and in need of adjustment. One outcome is for countries to undertake to renegotiate parts of the FTA or BIT for economic and political reasons, not unlike United States President-elect Obama's pledge to renegotiate parts of the NAFTA. The application of FTAs and BITs may also change as a result of domestic legislation impacting on investment, such as export and import control legislation, as well as regulations governing restrictive trade practices. Further developments in investment law and practice may derive from the decisions of investment tribunals or courts of law that are conceived to be controversial, including varying from the practices adopted under a particular BIT.<sup>86</sup>

A global-strategic concern is that the proliferation of BITs may erode the authority of multilateral institutions like the WTO.<sup>87</sup> Given the growth of BITs and FTAs, the global community arguably has less incentive to reach a multilateral accord on FDI. Typifying this lack of accord is the failure of the OECD Draft Multilateral Agreement on Investment (MAI). Despite its uniform principles and standards governing FDI, the OECD abandoned the draft agreement in the face of opposition to it by its member countries.<sup>88</sup>

Australia has generally been receptive to foreign investment in developing its domestic and foreign investment policies. Its general assumption has been that foreign investment enhances the economy and stimulates growth. Australia is also understandably committed to regulating the nature and extent of foreign ownership of Australian assets in the national interest. As a result, Australian BITs and investment provisions in its FTAs are fairly representative of most agreements negotiated by other countries. In particular, provision is made for resolving investment disputes between the country parties to such agreements, as well as permitting private investors from partner countries to proceed through arbitration against a host country that has allegedly violated the BIT in regard to that investor.<sup>89</sup>

However, Australia and its primary trade partners have avoided establishing a distinctive regime for resolving investment disputes (such as through a special arbitral regime set up under Ch 11 of the NAFTA between the United States, Canada and Mexico). At the same time, Ch 11 of the NAFTA is important to Australia, partly because of its FTA with the United States, because Australian businesses invest significantly in North America and in recognition of the influence of Ch 11 jurisprudence upon the law governing international investment generally.<sup>90</sup>

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<sup>86</sup> On the Australian Government's consideration of such issues, see *OECD Investment Committee*, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>87</sup> See generally Trakman, 'The Proliferation of Free Trade Agreements', *supra* n 69.

<sup>88</sup> On the failed MAI, see generally *MAI Negotiating Text* (24 April 1998), <<http://www.oecd.org/daf/cm/mai/maitext.pdf>>; Katie Tieleman, *The Failure of the Multilateral Agreement on Investment and the Absence of a Global Public Policy Network* (2000), <<http://www.gppi.net>>.

<sup>89</sup> See generally, *Bilateral Agreements*, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>90</sup> On the AUSFTA, see *infra* s 10.

## 12. Investor-State Disputes

However much countries are interested in FDI, host countries that regulate FDI vary in the manner in which they treat foreign investors, such as MCNs compared with individual investors. Various issues arise for consideration. What options do private investors have in responding to state regulation including the confiscation of investor assets? How might they so act, and with what legal consequences?

### xx. The Alternatives

Various methods of resolving investment disputes have been considered at different stages since World War II.<sup>91</sup> Countries can engage in diplomatic measures, particularly when the economic interests of home countries are significantly impacted by the treatment of their investors by host countries.<sup>92</sup> Failing diplomatic measures, a country can proceed against a host country before the ICJ, although such a resort is unlikely given that the rights of countries are not themselves directly in issue.<sup>93</sup> A further alternative is for home countries to resort to the WTO appellate dispute resolution process, such as under an investment specific agreement like the TRIMs Agreement.<sup>94</sup>

A more probable recourse is for foreign investors to proceed against host countries without relying on their home countries to act on their behalf. One such resort, notable in recent BITs, is for foreign investors to bring claim against host countries before domestic courts of those countries.<sup>95</sup> Another option is for foreign investors to bring claims before investment tribunals established by a BIT or FTA, such as under Ch 11 of the NAFTA. Those institutions function outside the purview of the host country; they are established under distinctive legal regimes such as the UNCITRAL Rules and the ICSID Convention.<sup>96</sup> Each has its own mechanisms for dispute resolution by international conventions that are recognised by signatory countries. Each also has distinctive rules and procedures governing the appointment of tribunal members and the conduct of hearings. Each appoints specialist investment tribunals whose decisions are binding on the parties and enforceable in law.<sup>97</sup>

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<sup>91</sup> On diplomatic measures to resolve state-on-state disputes, not limited to FDI, see the *UNCTAD Project on Dispute Settlement in International Trade, Investment and Intellectual Property*, <<http://www.unctad.org/Templates/WebFlyer.asp?intItemID=4403&lang=1>>.

<sup>92</sup> On the efficiency of public versus private enforcement of norms of international law including in relation to investment, see Alan O Sykes, 'Public Versus Private Enforcement of International Economic Law: Standing and Remedy' (2005) 34 *J Legal Stud* 631.

<sup>93</sup> However, Art 64 of the ICSID Convention provides that disputes between states that cannot be resolved by negotiation 'shall be referred to the International Court of Justice by the application of any party to such dispute, unless the States concerned agree to another method of settlement'. See further <[http://www.icsid.worldbank.org/ICSID/StaticFiles/basicdoc\\_en-archive/29.htm](http://www.icsid.worldbank.org/ICSID/StaticFiles/basicdoc_en-archive/29.htm)>.

<sup>94</sup> On this resistance, see *supra* s 5ii. See also, Andrew J Guzman, *supra* n 24.

<sup>95</sup> On such resort to resolve FDI disputes, see *infra* ss 6ii.

<sup>96</sup> See *infra* s 7iii(c).

<sup>97</sup> See generally Christopher Dugan, Don Wallace, Jr and Noah Rubins, *Investor-State Arbitration* (2008); Campbell McLachlan, Lawrence Shore and Matthew Weiniger, *International Investment Arbitration: Substantive Principles* (2007); Philippe Kahn and Thomas W Walde, *supra* n 30; Gue Van Hartlen, *Investment Treaty Arbitration and Public Law* (2007); Doak Bishop, James Crawford, W Michael Reisman, *Foreign Investment Disputes: Cases, Materials and Commentary* (2005); Todd Weiler, *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (2005); Norbert Horn, Stefan Kroll (eds), *Arbitrating Foreign Investment Disputes* (2004).

In practice, most BITs and FTAs refer disputes to investor-state arbitration. A limited alternative is for investment disputes to be referred to the domestic courts of host countries.<sup>98</sup>

### xxi. State Courts or State-Investor Tribunals?

There is an ongoing tension between submitting investment disputes to domestic courts and to international investment tribunals. Each has its protagonists and antagonists. Some countries that favour domestic courts are reluctant to ‘cede’ sovereignty, identified with the territorial jurisdiction of their courts, to independent arbitral tribunals.<sup>99</sup> Their motivations include mistrust of international arbitral procedures; concern over the application of investment law that is inconsistent with domestic law and conflicts with local interests; past practice and usage; and commercial and political expediency.<sup>100</sup> Their preference is either to avoid reliance on international investment tribunals, or to stipulate for extensive powers of judicial review before their domestic courts.<sup>101</sup> Typifying the preference among developed countries that domestic courts regulate FDI is the enactment of the 2002 Trade Act in the United States.<sup>102</sup> That Act reflects the preference of the United States Government to extend the authority of domestic courts to review investment awards under its most recently concluded BITs. The Act also restricts due process protections that might otherwise be accorded to foreign investors in favour of the more restrictive regulatory authority of the United States Government over foreign investment.<sup>103</sup>

In some measure, reliance of countries upon their domestic courts to resolve investment disputes in recent BITs reflects a backlash against investor-state dispute resolution mechanisms. This backlash is exemplified in the United States Government’s negative reaction to state-investor decisions in which investor-state tribunals have decided against the United States and in favour of foreign investors under Ch 11 of the NAFTA.<sup>104</sup> A very different justification for reliance on domestic courts arises when BIT parties express mutual

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<sup>98</sup> While the argument in favour of arbitration tribunals deciding investment disputes is usually couched as side-stepping domestic courts, critics have argued that tribunal decisions could prevail over local courts notably under Ch 11 of the NAFTA. See Dana Krueger, ‘The Combat Zone: *Mondev International, Ltd v United States and the Backlash against Chapter 11*’ (2003) 21 *Bu Int’l LJ* 399 (arguing that, but for a technical time bar, two tribunal decisions — *Mondev* and *Loewen* — might have prevailed over American judicial decisions). See *Mondev International LTD v United States of America*, ICSID Case No ARB (AF)/99/2 (Award) (11 October 2002); On the *Loewen* arbitration, see *Loewen Group, Inc v United States of America (Loewen)*, ICSID Case No ARB (AF)/98/3; William Dodge, ‘*Loewen v United States: Trial and Error Under NAFTA Chapter 11*’ (2002) 52 *DePaul L Rev* 563. On the judicial review of the *Loewen* Ch 11 decision, see Bradford K Gathright, ‘A Step in the Wrong Direction: The *Loewen* Finality Requirement and the Local Remedies Rule in NAFTA Chapter 11’ (2005) 54 *Emory LJ* 1093; William Dodge, *ibid.* See *infra* s 9 on the NAFTA.

<sup>99</sup> Arguably, this is the dilemma of the United States, Canada and Mexico in each ‘ceding’ its sovereignty to arbitration tribunals under Ch 11 of the NAFTA. See further *infra* s 9i, iv.

<sup>100</sup> On the AUSFTA, see *infra* s 10.

<sup>101</sup> Arguably, this concern includes that extra-judicial tribunals will take undue account of private economic interests of investors at the expense of the policy concerns of host states. This concern is redressed, in part, by the requirement that arbitrators decide in accordance with law rather than *ex aequo et bono*. See further Leon E Trakman, ‘*Ex Aequo et Bono: Demystifying an Ancient Concept*’ (2008) 8 *Chi J Int’l L* 621.

<sup>102</sup> The Trade Act was passed on 6 August 2002. See Trade Act 2002, Pub L No 107-210, 116 Stat 933, 994 (2002) (Trade Act).

<sup>103</sup> See further *infra* s 9vi.

<sup>104</sup> See further *infra* s 9i, viii.

confidence in each other's judicial system, as occurred under the AUSFTA; in such cases, the preference for domestic courts is expressed in part as a 'win' for the rule of law.<sup>105</sup>

Developing countries face a particular dilemma in choosing between domestic courts and independent investor-state tribunals. On the one hand, those countries worry that international investment tribunals may support the investment proclivities of foreign investors at the expense of their fledgling economies and natural resources. On the other hand, they fret that foreign courts exercising jurisdiction might favour local interests over investors from developing countries.<sup>106</sup>

### 13. Dispute Resolution Structures

Conflicts over FDI, theoretically, can be resolved between countries, such as between Australia and its BIT partners under the WTO; or such disputes can be resolved more immediately between investors and countries through the domestic courts of host countries or investment arbitration. This section addresses these different options, emphasising the process through which FDI disputes are resolved.

#### xxii. The WTO

There are a limited number of WTO conventions governing international investment and therefore limited prospects of reliance on intergovernmental agreements to resolve investment disputes. While unlikely to be readily invoked by countries to resolve specific investment disputes, WTO mechanisms theoretically can be used to resolve investment disputes between countries, as distinct from between private investors and host countries.<sup>107</sup>

The foundations of the WTO's dispute resolution mechanism lies in the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), dubbed Annex 2 of the WTO Agreement.<sup>108</sup> The DSU, in turn, consists of a rule-bound system of dispute resolution that purports to apply to all disputes falling under its aegis and embodied in its App 1. The Agreements which constitute the DSU include the multilateral trade agreements signed by all WTO members and the regional and bilateral trade agreements signed by some of them.<sup>109</sup>

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<sup>105</sup> On the negotiation of the AUSFTA, see Thomas Westcott, *Foreign Investment Issues in the Australia-United States Free Trade Agreement*, <[http://www.treasury.gov.au/documents/958/PDF/06\\_Foreign\\_investment\\_policy\\_AUSFTA.pdf](http://www.treasury.gov.au/documents/958/PDF/06_Foreign_investment_policy_AUSFTA.pdf)>.

<sup>106</sup> On the impact of this tension upon investment tribunals, see Patrick M Norton, 'A Law of the Future or a Law of the Past? Modern Tribunals and the International Law of Expropriation' (1991) 85 *Am J Int'l L* 74. See also G C Christie, 'What Constitutes a Taking of Property in International Law?' (1962) 38 *Brit YB Int'l L* 307; John Herz, 'Expropriation of Foreign Property' (1941) 35 *Am J Int'l L* 243, 251.

<sup>107</sup> On the significance of the WTO in resisting the liberalisation of FDI, see *infra* s 5i, ii.

<sup>108</sup> The WTO Agreement is relatively short. It consists of 16 Articles containing the institutional framework of the WTO. The annexes of the WTO Agreement contain all the specific multilateral agreements. See generally, Yang Guohua, Bryan Mercurio and Li Yonjie, *WTO Dispute Settlement Understanding: A Detailed Interpretation* (2005); Petros C Mavroidis and N David Palmeter, *Dispute Settlement in the World Trade Organization: Practice and Procedure* (2004). For a comprehensive list of publications on global commerce and the WTO, see <<http://www.henningcenter.berkeley.edu/gateway/wto.html>>; WTO, Secretariat, Legal Division, *A Handbook on the WTO Dispute Settlement System* (2004); WTO, Secretariat, *The WTO Dispute Settlement Procedures: A Collection of the Relevant Legal Texts* (2001).

<sup>109</sup> WTO Agreement, Annex 4 and DSU, App 1.

Unifying the WTO dispute settlement system is an attempt to arrive at a body of law governing multilateral trade that is widely endorsed by countries, clear in its rules of application and efficient in its outcomes. The goal is to encourage compliance as well as the enforcement of WTO obligations.<sup>110</sup> Only member governments receive standing as parties to its dispute resolving mechanisms. Private parties and non-governmental organisations lack standing to appear. Their only means of access is through the action of governments adopting their non-governmental causes, or in limited cases, by a WTO grant of *amicus curiae* status to non-governmental organisations.<sup>111</sup>

The WTO dispute resolution mechanism represents a global order used to regulated international trade and to a limited extent, FDI. Strategically, the WTO mechanism operates as a framework of principles, standards, rules and procedures within which countries like Australia can resolve disputes with their BIT partners, including in relation to the subjects of home countries. However, WTO dispute resolution procedures are more readily applicable to trade than investment disputes because of the comparative paucity of WTO treaties on international investment, the resistance of developing countries *en masse* to the liberalisation of international investment, and concern among developed and developing countries towards the unchecked movement of capital across national boundaries.<sup>112</sup>

Despite its limitations in liberalising international investment, the WTO's dispute resolution mechanism applies to particular international investment treaties: TRIMs regulating investment measures under principles of the GATT and the WTO; the Agreement on TRIPS limiting investment in trade-related intellectual property rights; and the Agreement on Subsidies and Countervailing Measures (SCM) redressing distortions in trade and investment arising from subsidies and countervailing measures. Nevertheless, the WTO is unlikely to be extensively applied to disputes over FDI, largely because countries can invoke general exceptions to avoid liability. For example, signatory countries to the GATS can invoke the general exception contained in Art XVII to avoid liability for regulating investments in services, a practice which is replicated in more recent BITs.<sup>113</sup>

In contrast, it is conceivable that Australia or its BIT partners could invoke the dispute resolution measures of the WTO outside of the ambit of specific treaties like the GATS to resolve investment disputes with other countries, including on behalf of their home investors.<sup>114</sup>

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<sup>110</sup> DSU, Arts 3.2, 19.2.

<sup>111</sup> The standing of NGO's in dispute resolution in WTO proceedings is determined *ad hoc*; as a result, the status of NGOs in proceedings is subject to different perceptions of both their *per se* 'right' to be heard and to make representations and the perceived public interest served by their participation.

<sup>112</sup> On the resistance of the WTO to the liberalisation of FDI, see *supra* s 5i.

<sup>113</sup> On the GATS, see <[http://www.wto.org/english/tratop\\_e/serv\\_e/gatsqa\\_e.html](http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.html)>.

<sup>114</sup> On efforts by the WTO to resist alleged corporate excesses over global trade and investment, see, for example, Lori Wallach and Michelle Sforza, *The WTO: Five Years of Reasons to Resist Corporate Globalization* (2000).

### xxiii. Investor-State Institutions

There are three primary arbitration facilities used to resolve international investment disputes between private investors and countries: the Convention on the Settlement of Investment Disputes (ICSID),<sup>115</sup> the ICSID Additional Facility<sup>116</sup> and the UNCITRAL.<sup>117</sup>

There are also discrete mechanisms established under particular regional agreements that provide for the resolution of private investor-state disputes. Most prominent among these is Ch 11 of the NAFTA providing for arbitral tribunals to resolve investment disputes between a host NAFTA party and an investor from another NAFTA country. While the NAFTA has its own peculiar procedural and substantive mechanisms for resolving investment disputes, those disputes are often addressed under the rules of existing arbitration facilities, including the UNCITRAL Rules, the ICSID and the ICSID Additional Facility depending on whether the NAFTA host country is a party to the applicable international convention. As a result, these facilities are important to all state parties to these conventions, including Australia and its investors abroad.<sup>118</sup>

Each of these institutions for hearing international investment disputes will be discussed briefly, including, where applicable, the processes for the review of their decisions.<sup>119</sup>

#### a. The ICSID

The most significant multilateral development in the resolution of investor-state disputes traces back to the establishment of the ICSID in 1965, which is widely accepted internationally as a primary instrument for the settlement of investment disputes. The ICSID not only provides multilateral legitimacy in the settlement of investment disputes. It also serves as a dispute resolution protocol that countries can incorporate into their BITs without having to rely on the domestic courts of other countries to resolve FDI disputes.<sup>120</sup>

Affiliated with the World Bank, the ICSID also provides facilities for the conciliation and arbitration of investment disputes between foreign investors and host governments. Arbitration under the ICSID is administered through the Centre for the Settlement of International Disputes, located on the premises of the World Bank in Washington DC. Key to the ICSID is its principles and processes for the arbitration of investment disputes.<sup>121</sup>

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<sup>115</sup> On the ICSID generally, see <<http://www.worldbank.org/icsid>>.

<sup>116</sup> ICSID Additional Facility Rules are available at the World Bank website: <<http://www.worldbank.org/icsid/basic-doc-archive/9.html>>.

<sup>117</sup> UNCITRAL Arbitration Rules, GA Res 31/98, UN UNCITRAL, 99th Plen Mtg (15 Dec 1996) (UNCITRAL Rules), <<http://www.uncitral.org/pdf/english/texts/arbitrationarb-rules/.pdf>>. See too, Jan Paulson and Georges Petrochilos, *Revision of the UNCITRAL Arbitration Rules*, <[http://www.uncitral.org/pdf/english/news/arbrules\\_report.pdf](http://www.uncitral.org/pdf/english/news/arbrules_report.pdf)>.

On dispute resolution mechanisms under Ch 11 of the NAFTA, see *infra* s 9iii–viii.

<sup>118</sup> On regional investment agreements, see Stephen Woolcock, *The Role of Regional Agreements in Trade and Investment Regimes* (2008).

<sup>119</sup> On international investment claims and decisions generally, see <<http://www.investmentclaims.com/>>.

<sup>120</sup> Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, 18 March 1965, 17 UST 1270, TIAS No 6090, <<http://www.worldbank.org/icsid>>.

<sup>121</sup> *Ibid.*

ICSID arbitrations are widely used and incorporated by reference into a variety of regional and bilateral investment agreements. ICSID arbitrations have also added to the jurisprudence on international investment law, such as by extending the meaning of a ‘government taking’ to include a ‘taking’ by contract.<sup>122</sup> Some ICSID cases are also extensively publicised including among parties to regional agreements with their own arbitral mechanisms, notably under the NAFTA.<sup>123</sup>

The ICSID provides for a review of an investment award by an Annulment Committee which is set up specifically for that purpose, with the power to modify or nullify an ICSID award on limited procedural grounds under Art 75 of the ICSID Convention.<sup>124</sup> Either party can request that the award be annulled. However, the grounds for such a challenge are restricted and fall short of an appeal. They include that:

- 1) the ICSID tribunal was not properly constituted;
- 2) the tribunal manifestly exceeded its powers;
- 3) there was corruption on the part of a tribunal member;
- 4) there was a serious departure from a fundamental rule of procedure; or
- 5) the award failed to state the reasons on which it was based.

ICSID Annulment Committees traditionally have interpreted these grounds for a challenge liberally, permitting a series of challenges, although such challenges have dissipated in recent years.<sup>125</sup> Resort to domestic courts is not an option under the ICSID.

#### **b. The ICSID Additional Facility**

The ICSID Additional Facility was established in 1978 to provide more effective access to the ICSID dispute resolution regime. The ICSID Additional Facility regime has rules that differ from the ICSID, notably to accommodate disputes in which either the host country or the home country of the foreign investor is not a member of the ICSID Convention.<sup>126</sup>

The ICSID and the ICSID Additional Facility Rules both provide that tribunals hold their first hearing within 60 days from the date of constituting the tribunal, or as otherwise agreed to by the parties. However, all the other timelines are within the discretion of the tribunal and are

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<sup>122</sup> See, for example, *Mondev International LTD v United States of America*, ICSID Case No ARB (AF)/99/2 (Award) (11 October 2002). This case involved a claim by a Canadian investor that the assertion of sovereign immunity by the state of Massachusetts violated Art 1105 of the NAFTA and included contract claims. See further Dana Krueger, *supra* n 98. But see *Société Générale de Surveillance SA v Islamic Republic of Pakistan*, ICSID Case No ARB/01/13, decision on jurisdiction dated 6 August 2003 at [167] (‘under general international law, a violation of a contract entered into by a State with an investor of another State, is not, by itself, a violation of international law’).

<sup>123</sup> See *ibid*, *Mondev International*. See further *supra* nn 98, 122.

<sup>124</sup> On Art 75, see <[http://www.icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR\\_English-final.pdf](http://www.icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf)>.

<sup>125</sup> On ICSID documents generally, see <<http://www.worldbank.org/icsid>>. See also James Crawford and Karen Lee, *ICSID Reports* (2004).

<sup>126</sup> On the ICSID Additional Facility, see <<http://www.worldbank.org/icsid/basic-doc-archive/9.html>>.

ordinarily reached in consultation with the ICSID Secretary General as well as the disputing parties.<sup>127</sup>

### c. The UNCITRAL Arbitration Rules

UNCITRAL was established in 1966 and most countries, including Australia, are signatories. Its purpose is to harmonise and unify international trade law. Functioning through working groups on specific projects,<sup>128</sup> its Arbitration Rules were devised specifically to provide member countries with a unified and ordered method of arbitrating disputes on trade and investment.<sup>129</sup> Its procedural framework for resolving international arbitration is widely recognised and incorporated into various international trade and investment agreements between countries.<sup>130</sup> Its rules are also easy to adopt and can be used by any party including non-state actors that are not members of, or affiliated with, any international association.<sup>131</sup>

The UNCITRAL Arbitration Rules provide that the parties to an investment dispute exchange pleadings within 45 days of the initiation of proceedings.<sup>132</sup> The Rules do not prescribe timelines for the duration of hearings, giving the appointed tribunal wide latitude in setting timelines.<sup>133</sup> The result is that UNCITRAL proceedings can be dilatory unless the tribunal resolves to proceed expeditiously.

Consistent with international commercial arbitration practice, neither the ICSID nor the ICSID Additional Facility Arbitration Rules provide for an appeal on the merits. They limit jurisdiction to review based on the interpretation of awards, to redress procedural irregularities and to correct arithmetic and other clerical errors. They also provide for the enforcement, modification, or annulment of awards on their merits. Consistent with international arbitration practice, the UNCITRAL and ICSID Additional Facility awards may be challenged under the commercial arbitration laws of the place of arbitration.<sup>134</sup>

### d. Distinctive Attributes

The ICSID, ICSID Additional Facility and UNCITRAL Arbitration Rules each have their own distinctive procedures for resolving international investment disputes in respect of which Australia and its investors ought to be cognisant. What they share is the value they place on appointing arbitrators to resolve trade and investment disputes and the discretion accorded to appointed arbitrators to manage proceedings and make binding awards. Both the ICSID Additional Facility rules and the UNCITRAL Rules permit arbitral tribunals to establish

<sup>127</sup> On the appointment and role of the Secretary General of the ICSID, see (23 February 2009), <<http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=OpenPage&PageType=AnnouncementsFrame&FromPage=Announcements&pageName=Announcement15>>.

<sup>128</sup> On this mission of the UNCITRAL, see *Working Group on Arbitration and Conciliation on the Work of its Forty-second Session* (10–14 January 2005), A/CN.9/573, at <<http://www.uncitral.org>>. See also G Hermann, 'The UNCITRAL Arbitration Law: A Good Model of a Model Law' (1998) *Uniform L Rev* 83.

<sup>129</sup> On this procedural framework, see, for example, Alan Redfern and Martin Hunter, *Law and Practice of International Commercial Arbitration* (2nd ed, 1991) 479–80.

<sup>130</sup> See, for example, Amanda Debusk, 'Investor Dispute Resolution Under the NAFTA' in Nick Ranieri (ed), *Nuevos Horizontes* (1997) 231.

<sup>131</sup> See <[http://www.uncitral.org/pdf/english/news/arbrules\\_report.pdf](http://www.uncitral.org/pdf/english/news/arbrules_report.pdf)>.

<sup>132</sup> See UNCITRAL Arbitration Rules Art 23.

<sup>133</sup> *Ibid* Art 23 (entitling the tribunal to extend the 45-day period for exchanging pleadings 'if it concludes that an extension is justified').

<sup>134</sup> See generally <<http://www.worldbank.org/icsid/basic-doc-archive/9.html>>.

procedural orders to govern the conduct of proceedings. However, the ICSID Additional Facility rules require that the tribunal apply the agreement of the parties on procedural matters. As a further distinction, the UNCITRAL Rules provide for confidential hearings unless the parties agree otherwise; the ICSID Additional Facility does not so provide.<sup>135</sup>

Awards under all three arbitration regimes are reached by a majority of the tribunal. In practice, two arbitrators may agree on an award, but differ on the amount. This is an issue under the UNCITRAL Rules in which the tribunal may reach a majority decision, but fail to agree on the award of damages.<sup>136</sup>

The ICSID, like the ICSID Additional Facility, leaves costs to the tribunal, subject to guidelines established by the ICSID Administrative Council. As a matter of practice, ICSID proceedings commence by requiring the parties to make an advance deposit to defray costs, usually in equal shares. A risk is that one party may decline to pay the deposit, forcing the other to advance the full amount in order to proceed. A further result is that the defaulting party may significantly impede the tribunal process.<sup>137</sup>

The traditional rule, that the losing party should pay costs, is not consistently adopted by arbitral tribunals including under the UNCITRAL Rules.<sup>138</sup> Inherent in that ‘rule’ was the assertion that foreign investors who lost against host countries were bound to pay costs in order to discourage speculative investor claims against sovereign countries. This ‘traditional’ rule may be changing. If the award on costs in the NAFTA investment case of *Methanex v United States* is followed, investment tribunals applying the UNCITRAL Rules may be willing to rule against foreign investors while not requiring them to pay costs.<sup>139</sup>

## 14. Functional Alternatives

An important issue for international investment tribunals as well as domestic courts charged with jurisdiction over FDI, including in Australia, is to decide particular cases without becoming captive to the claims of countries or foreign investors. Tribunals need to weigh formal assertions of state sovereignty against the manner in which countries exercise those powers in discrete cases. Investment tribunals also need to decide cases in a principled manner, while effectively balancing the power of countries to regulate FDI against the reasonable expectations of foreign investors. Their greatest challenge is in coherently treating similar cases similarly and different cases differently in responding to specific questions: When is a ‘government taking’ by the Government of Australia or by one of its BIT partner countries legitimate? What criteria should tribunals employ to reach decisions in regard to such a ‘taking’? And what legal consequences ought to arise from such a decision?<sup>140</sup>

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<sup>135</sup> See <<http://www.uncitral.org/pdf/english/texts/arbitrationarb-rules/.pdf>>; <<http://www.worldbank.org/icsid>>.

<sup>136</sup> *Ibid.*

<sup>137</sup> See *ICSID Basic Documents, Administrative and Financial Regulations*, <<http://www.worldbank.org/icsid>>.

<sup>138</sup> See UNCITRAL Rules Art 40(1).

<sup>139</sup> See *Methanex Corporation v United States (Methanex)*, <<http://www.naftaclaims.com>>.

<sup>140</sup> Also in issue is the nature and extent of harmonisation of international investment law, not limited to harmonising common and civil law systems. See Siegfried H Elsing and John M Townsend, ‘Bridging the Common Law-Civil Law Divide in Arbitration’ (2002) 18(1) *Arbitration Int’l* (LCIA); Jack Coe, Jr, *International Commercial Arbitration: American Principles and Practice in a Global Context* (1997).

## xxiv. The Legal Issues

The regulation of FDI under customary international law is about ensuring that foreign investors in Australia and abroad receive natural justice, that their substantive rights are not trammelled, and that they are not subject to executive fiat or arbitrary legal proceedings. Behind the trappings of natural justice are pervasive concerns about the reasonable boundaries within which host countries exercise sovereign authority, the fair treatment they accord foreign nationals, and their ‘permissible’ limits of leeway in policing foreign investments and in acting in the public interest.<sup>141</sup>

As an illustration, determining whether a ‘*de facto* expropriation’ of FDI of Australian investments abroad constitutes a reasonable exercise of governmental discretion raises pragmatic questions about ‘why’, ‘when’, ‘how’ and ‘to what extent’ the expropriation of property is legally permissible.<sup>142</sup> The issue is not whether Australia or another country has the power to expropriate. It is instead whether its ‘expropriation’ of a particular foreign investment is ‘reasonable’; whether the foreign investor is subject to a ‘fair process’; and whether compensation paid, if at all, is ‘adequate.’ Answering these questions raises issues of principle, such as whether that country has exercised its ‘taking’ powers in a manner that is legitimate.<sup>143</sup> It also raises functional questions, such as over the extent to which that government ‘taking’ complies with natural justice or due process of law. In contention is not whether a sovereign country has the power to expropriate or nationalise property, which it invariably does have. In issue is whether the exercise of that power accords with responsibilities arising by operation of customary international investment law or treaty which that country owes to foreign investors.<sup>144</sup>

## xxv. Procedural Restrictions on State Powers

Procedural limits over the powers of a country like Australia and its investment partners to regulate FDI include: whether investment tribunals or courts in host states have subjected foreign investors to differential standards of treatment in otherwise similar cases; the reasons for such differences in treatment; and the justification for those differences. The principled subtext is whether investment tribunals apply such standards in a transparent, consistent and equitable manner.

Illustrating their procedural limits on state powers is the requirement that countries accord ‘fair and equitable treatment’ to foreign direct investors, including whether they respect their ‘reasonable expectations’.

### a. Fair and Equitable Treatment

A central concept in the protection of private investment under international law is the principle that foreign direct investors receive ‘fair and equitable treatment’ from host

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<sup>141</sup> See *supra* s 8iii. See also, generally, Stephen Schwebel, ‘On Whether the Breach by a State of a Contract with an Alien is a Breach of International Law’, in *International Law at the Time of its Codification 401* (1987).

<sup>142</sup> For a classical discussion of the issues surrounding expropriation under international investment law in light, *inter alia*, of the sovereignty of states, see, for example, John Herz, *supra* n 106.

<sup>143</sup> On the meaning attributed to ‘fair’ and ‘equitable’ treatment, see, for example, Christoph Schreuer, *supra* n 74. See also *infra* s 8ii, a.

<sup>144</sup> See generally Matthew C Porterfield, ‘International Expropriation Rules and Federalism’ (2004) 23(3) *Stan Envtl LJ*.

countries like Australia, its BIT partners and other countries in which Australian investors have interests abroad. The problem lies in uncertainty over the nature of such ‘treatment,’ the manner in which it is applied to complainant direct investors and its legal effect.<sup>145</sup>

How should the ‘fair’ and ‘equitable’ treatment of foreign direct investors in Australia or abroad be measured? According to what criteria should investment tribunals assess whether a host country like Australia has interfered ‘unfairly’ with investor expectations? These questions raise procedural and substantive considerations. For example, they focus on the manner in which a host country notified a foreign investor about an impending exercise of police powers, the abruptness and severity of that exercise, and the degree to which a foreign direct investor was unreasonably surprised by that state action. In issue is the severity of impact that a host country’s ‘taking’ has upon a foreign investor, the manner in which it reasonably forewarned that foreign investor, the reasonable surprise of that investor and its ability to avert the consequences of that ‘taking’ in the circumstances.<sup>146</sup>

The jurisprudence on ‘fair and equitable treatment’ is neither settled internationally, nor uniform across the jurisprudence of individual countries.<sup>147</sup> Rather than apply it consistently to foreign investors, investment tribunals construe ‘fair and equitable’ treatment variably in response to differences in the applicable law, competing assertions of state sovereignty and variations in public policy concerns. In the absence of a coherent body of legal principle, ‘fair and equitable treatment’ is, at best, based on imputations of the reasonableness of state action and the reasonable reactions of foreign investors to that action. Included among investor reactions is the reasonableness of their assumptions about the host country’s representations, the precautions taken by those foreign direct investors in protecting their property rights and the extent of the host country’s infractions upon those rights notwithstanding those precautions.<sup>148</sup>

## **b. Legitimate Expectations**

According to ‘fair and equitable’ treatment to foreign direct investors in Australia and to Australian direct investors abroad includes protecting their ‘legitimate expectations’. The

<sup>145</sup> On the standards of treatment in regulating FDI considered by the Australian Government under the WTO, see generally *WTO Dispute Settlement*, <<http://www.dfat.gov.au/trade/negotiations/index.html>>.

<sup>146</sup> See generally Christoph Schreuer, *supra* n 74, p 374.

<sup>147</sup> On the ‘fair and equitable’ treatment standard in investment treaties, see, for example, Christoph Schreuer, *supra* n 74; Stephen Vasciannie, ‘The Fair and Equitable Treatment Standard in International Investment Law and Practice’ (2002) 70 *Brit YB Int’l L* 99; J C Thomas, ‘Reflections on Article 1105 of NAFTA: History, State Practice and the Influence of Commentators’ (2002) 17 *ICSID Rev For Inv LJ* 21; Barnali Choudhury, ‘Evolution Or Devolution? Defining Fair and Equitable Treatment in International Investment Law’ (2005) 6 *J World Inv’t & Trade* 297; Courtney Kirkman, ‘Fair and Equitable Treatment: Methanex v United States and the Narrowing Scope of NAFTA Article 1105’ (2002) 34 *Law & Pol’y Int’l Bus* 343; Patrick Dumbery, ‘The Quest To Define “Fair and Equitable Treatment” for Investors Under International Law: The Case of the NAFTA Chapter 11 Pope & Talbot Awards’ (2002) 3 *J World Inv* 657. See also, *OECD Working Paper on International Investment, Fair and Equitable Treatment Standard in International Investment Law* (Directorate for Financial and Enterprise Affairs, 2004/3), <<http://www.oecd.org/dataoecd/22/53/33776498.pdf>>.

<sup>148</sup> Typifying these variable conceptions of ‘fair and equitable’ treatment is a series of cases commencing with the ICSID award in *Maffezini v Kingdom of Spain*, ICSID Case No ARB/97/7, Award on the merits, 13 November 2000, <<http://www.ita.law.uvic.ca/documents/Maffezini-Award-English.pdf>> at para 64; *MTD Equity Sdn Bhd & MTD Chile SA v Chile*, ICSID Case No ARB/01/7, 25 May 2004, <<http://www.ita.law.uvic.ca/documents/MTD-Award.pdf>> at para 178; and Ian A Laird, ‘MTD Equity Sdn Bhd and MTD Chile SA v Republic of Chile — Recent Developments in the Fair and Equitable Treatment Standard’ (October 2004) 1(4) *Transnational Dispute Management*.

'legitimate expectations' of foreign direct investors are based on, among other factors, the express or implied representations made by the host country to foreign investors, and the reasonable expectations of direct investors arising from those representations. These determinations depend on the nature and severity of changes in the representations made by that host country, the stated or inferred reasons for those changes and the reasonable effect of changes in the host country's representations upon the expectations of foreign investors. Expressed in terms of due process, an Australian investor's legitimate expectations abroad include that a host country ought not to apply its regulatory framework in a substantively and procedurally unfair manner in relation to that investor.<sup>149</sup>

Investment tribunals have used objective measures to determine whether a host country has treated a foreign investor 'unfairly' and contrary to that investor's 'legitimate expectations'. For example, in *Saluka v Czech Republic*, the tribunal explicitly rejected a subjective standard, stating:<sup>150</sup>

[T]he scope of the Treaty's protection of foreign investment against unfair and inequitable treatment cannot exclusively be determined by foreign investors' subjective motivations and considerations. Their expectations, in order for them to be protected, must rise to the level of legitimacy and reasonableness in light of the circumstances.

In determining the reasonable expectations of foreign investors 'in light of the circumstances', investment tribunals have sought to balance the legitimate expectations of host countries in the exercise of their powers against the reasonable expectations of foreign investors in relation to that exercise. They have also taken account of the changing legal, economic and social environment in engaging in that balance. For example, an investment tribunal has held that a foreign investor cannot reasonably expect to receive the same treatment from a host country in the face of material changes in economic and social conditions within that country. As the tribunal opined in *Saluka v Czech Republic*:

No investor may reasonably expect that the circumstances prevailing, at the time the investment is made, remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well.<sup>151</sup>

Ultimately, investment tribunals are likely to determine that the expectations of governments are 'legitimate' or 'illegitimate' according to a mix of subjective and objective criteria. No

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<sup>149</sup> On such 'legitimate expectations', see *Saluka Investments BV (The Netherlands) v The Czech Republic*, Partial Award, 17 March 2006, <<http://www.ita.law.uvic.ca/documents/Saluka-PartialAwardFDInal.pdf>> at para 304; *Waste Management, Inc v The United Mexican States*, ICSID Case No ARB (AF)/00/3 (NAFTA), Final Award, 30 April 2004, at <[http://www.ita.law.uvic.ca/documents/laudo\\_ingles.pdf](http://www.ita.law.uvic.ca/documents/laudo_ingles.pdf)> at para 98; *International Thunderbird Gaming Corporation v Mexico*, UNCITRAL (NAFTA), Arbitral Award, 26 January 2006, at <<http://www.ita.law.uvic.ca/documents/ThunderbirdAward.pdf>> (*Thunderbird*) at para 147; *GAMI Investments Inc v The Government of the United Mexican States*, Final Award, 15 November 2004 (UNCITRAL Arbitration), at <<http://www.ita.law.uvic.ca/documents/Gami.pdf>> at para 100. See also Stephan W Schill, 'Fair and Equitable Treatment Under Investment Treaties as an Embodiment of the Rule of Law' (December 2006) 3(5) *Transnational Dispute Management* 16.

<sup>150</sup> See *Saluka*, para 304, <<http://www.asil.org/ilib/2006/04/ilib060412.htm#j3>>. See also <[http://www.pca-cpa.org/showpage.asp?pag\\_id=1149](http://www.pca-cpa.org/showpage.asp?pag_id=1149)>.

<sup>151</sup> See *Saluka*, *ibid.*, para 300. But cf *CME Czech Republic BV v The Czech Republic*, Partial Award, 13 September 2001, 9 ICSID Reports 12. See also *Técnicas Medioambientales Tecmed, SA v United Mexican States*, ICSID Case No ARB (AF)/00/2, Award dated 29 May 2003, <[http://www.ita.law.uvic.ca/documents/Tecnicas\\_001.pdf](http://www.ita.law.uvic.ca/documents/Tecnicas_001.pdf)> at para 160.

matter how much they try to avoid subjective standards of measurement, they cannot measure the reasonableness of a country's exercise of sovereignty without taking cognisance of its subjective conception of that self-same sovereignty. Similarly, tribunals cannot measure the 'reasonable expectations' of Australian direct investors abroad without taking account of their actual expectations. Illustrating the delicate balance between subjective and objective measures of 'legitimate' investor expectations is the *Thunderbird* investment claim brought against the Mexican Government under Ch 11 of the NAFTA and decided under the UNCITRAL Arbitration Rules.<sup>152</sup> In that case, the tribunal weighed the actual representation made by the Mexican Government prior to its 'taking' and concluded that it had not generated a sufficiently 'legitimate expectation' upon which the claimant investor reasonably could rely in the circumstances.<sup>153</sup>

## xxvi. Substantive Restrictions on State Powers

### c. A Principled Approach

A substantive concern for Australian investors abroad or foreign investors in Australia is to determine the policies, principles and standards underlying the exercise of a country's 'police powers,' the manner in which it conceives of those powers. In issue are the normative values that ground those policies, principles and standards, the functions they are meant to perform and the actual results of their exercise in specific cases. At their most pervasive, the police power of countries forms part of binding international law, the *ius cogens*; and the opinion of investment tribunals constitute part of the *opinio juris* on FDI. At their most particular, the exercise of police powers is peculiar to the domestic public policy of host countries and investors and has no place in the international jurisprudence governing FDI.<sup>154</sup>

### d. The Exercise of Police Powers

The police power of countries like Australia is a key justification for the expropriation of foreign investment.<sup>155</sup> In issue is not simply that countries may exercise those powers in an arbitrary and excessive manner, but also the extent to which their exercise may disregard pre-existing norms of international investment law.<sup>156</sup> The conclusion that a particular interference is an expropriation might also be avoided if the country whose actions are the subject of complaint had a purpose in mind which is recognised in international law as justifying even severe, although by no means complete, restrictions on the use of property.<sup>157</sup>

The normative basis for the exercise of police powers resides in the sovereign authority of countries to act in the public interest. The extent of their police powers is contingent upon the source, the reason for and manner of invoking those powers, as well as their particular effect

<sup>152</sup> See *International Thunderbird Gaming Corporation v Mexico*, UNCITRAL (NAFTA), Arbitral Award, 26 January 2006, at <<http://www.ita.law.uvic.ca/documents/ThunderbirdAward.pdf> (*Thunderbird*)>.

<sup>153</sup> *Ibid* at para 304.

<sup>154</sup> See further John Herz, *supra* n 106. See too Tamada Dai, *Categories of Rulings on Compensation and Reparation in the International Investment Arbitration: A Tentative Reclassification of Cases*, Research Institute of Trade, Economy and Industry (IAA), <<http://www.rieti.go.jp/en/publications/summary/08060008.html>>.

<sup>155</sup> See, for example, Celine Levesque, 'Distinguishing Expropriation and Regulation Under NAFTA Chapter 11: Making Explicit the Link to Property' in Kevin Kennedy (ed), *The First Decade of NAFTA: the Future of Free Trade in North America* (2004); Marc Poirier, 'The NAFTA Chapter 11 Expropriation Debate through the Eyes of a Property Theorist' (2003) 33 *Env'l L* 851; John Herz, *supra* n 106 at p 251.

<sup>156</sup> *Ibid* at 306.

<sup>157</sup> George C Christie, *supra* n 106, at pp 331–2.

upon complainant foreign direct investors. For example, the source of Australia's power may reside in its monetary, fiscal, tax, or penal authority; alternatively, its exercise of that authority may be based on its interest in public health, social welfare and environmental safety. The reason for Australia invoking that power may arise, *inter alia*, from its economic policy, social welfare, or through protection of the environment. The effect of its exercise of police powers may vary widely from imposing a duty, levy, or tax upon a complainant foreign investor and regulating the manner in which that investment minimises upon risks to public health, safety and the environment.<sup>158</sup>

The source of Australia's police power does not, in and of itself, determine the extent to which it can legitimately exercise that power in fact. For example, however justifiable the reason may be for it to 'take' FDI on grounds of public health and safety, its 'taking' still may be deemed to be punitive. For example, the taking may be insufficient related to the public health reason invoked to justify it; or the taking may have a disproportionately more harmful effect upon the complainant foreign investor than the public health benefit. Conversely, a monetary regulation of FDI that denies full compensation to a complainant investor may be deemed to be reasonable on grounds of the dire economic conditions it has upon the Australian public, or upon segments of it.<sup>159</sup>

The legitimate reach of Australia's police powers is ultimately circumscribed according to whether its exercise is deemed to be reasonable. Determining that reasonableness depends, *inter alia*, on whether the foreign investor: was properly notified of the application of those police powers; was accorded natural justice; and whether the exercise of those powers caused that investor unjustified or excessive harm.<sup>160</sup> A key issue is the extent to which Australia ought reasonably to have compensated foreign investors for exercising police power, whether grounded on national security, public safety, or monetary, tax and fiscal policy.<sup>161</sup>

Decision-makers accord countries variable latitude in regulating FDI for the 'public good.' Establishing that the exercise of police powers is excessive hinges on the legitimacy that is imputed to that exercise, the availability of alternative and less invasive measures to the country and the impact of the measures actually adopted upon the complainant investor.<sup>162</sup>

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<sup>158</sup> See, for example, Celine Levesque, *supra* n 155.

<sup>159</sup> *Ibid* at 305.

<sup>160</sup> Courts have long grappled with the question of where property rights end and public regulation begins. See *Hudson Water Co v McCarter*, 209 US 349, 355 (1908) (Holmes J). ('The boundary at which the conflicting interests balance cannot be determined by any general formula in advance, but points in the line, or helping to establish it, are fixed by decisions that this or that concrete case falls on the nearer or farther side'.) See generally Marc Poirier, *supra* n 155; and Celine Levesque, *supra* n 155.

<sup>161</sup> On a recent NAFTA claim against Canada over its environmental assessment process in regard to a proposal for basalt quarry and oceanic shipping from the coastal province of Nova Scotia to the United States, see *Investment Arbitration Reporter* (28 July 2008), <<http://www.iareporter.com/Archive/IAR-07-28-08.pdf>>. For criticisms of Dow Chemical challenging the Canadian Government's environmental protection regulations under Ch 11 of the NAFTA, see 2(1) *Investment Arbitration Reporter*, 3 June 2008, <<http://www.iareporter.com/Archive/IAR-06-03-08.pdf>>.

In effect, compensation is grounded in both the kind and degree of the national interest that is the subject of protection. See *supra* s 8iii, a.

<sup>162</sup> See Julie Solway and Howard Mann, *Report to the Ad Hoc Group on Investment Rules and the Department of Foreign Affairs and International Trade*, <<http://www.dfait-maeci.gc/tna-nac/regulation-en.asp>>. See further George C Christie, *supra* n 106, at 331–2.

## 15. Chapter 11 of the NAFTA

In the absence of a meaningful multilateral treaty on FDI, Ch 11 of the NAFTA between the United States, Canada and Mexico has evolved into the most influential supranational body of investment law. A well tested, while arguably flawed, template for regional investment treaties, it provides measured safeguard protection for FDI including in dispute resolution.<sup>163</sup> Some Ch 11 decisions, such as the minority decision of Dean Cass in *UPS v Canada*, arguably have articulated coherent statements on the nature and limits of a 'government taking.'<sup>164</sup>

As a result, Ch 11 serves not only as an early warning signal of regulatory practice in relation to the expropriation of FDI. It also represents an authoritative albeit controversial body of investment law that is cited by investment tribunals well beyond NAFTA tribunals and its member countries. In these respects, Ch 11 of the NAFTA is relevant to Australia, particularly given significant investments by Australians in the NAFTA countries and vice versa. At the same time, Ch 11 should be viewed cautiously as a classic BIT that emphasises the extensive liberalisation of FDI that more recent BITs sometimes have avoided.<sup>165</sup>

### xxvii. The Foundations of the NAFTA

The NAFTA is a modern trade and investment agreement that circumscribes the power of each NAFTA party in relation to investors from other NAFTA home countries. It also brings together partners with shared aspirations. Mexico and Canada had a common interest in building more enduring trade and investment ties with the United States, while fearing United States investment expansionism. Both wished also to preserve their socio-cultural traditions and political distinctiveness.<sup>166</sup>

Not unlike differences in investment philosophies among investment partners in the region shared by Australia, the NAFTA partners also have significant different foreign investment philosophies in their North American region. The most pronounced are those politico-economic differences between the United States and Mexico. The United States traditionally sought investment expansionism. In contrast, Mexico resisted such expansionism. The United States adopted a nineteenth century philosophy grounded in the responsibility of countries to accord a 'minimum standard of treatment' to foreign investment.<sup>167</sup> Mexico subscribed to the

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<sup>163</sup> Ari Afilalo, 'Meaning, Ambiguity and Legitimacy: Judicial (Re-) Construction of NAFTA Chapter 11' (2004) 25 *NW J Int'l L & Bus* 279. See also Patricia Isela Hansen, 'Dispute Settlement in NAFTA and Beyond' (2005) 40 *Tex Int'l J* 417. See also, Joseph Strazzeri and A Lucas, 'Analysis of Regulatory Expropriations under NAFTA Chapter Eleven' (2002) 14 *Geo Wash Int'l L Rev* 837.

<sup>164</sup> Decided on 11 June 2007: see <[http://www.naftaclaims.com/disputes\\_canada.ups.html](http://www.naftaclaims.com/disputes_canada.ups.html)>. For a useful, albeit self-serving, interpretation of the UPS decision, see <[http://www.cupw.ca/index.cfm/ci\\_id/9654/la\\_id/1.html](http://www.cupw.ca/index.cfm/ci_id/9654/la_id/1.html)>.

<sup>165</sup> For a discussion on these more recent BIT developments, see, for example, Jürgen Kurtz, *supra* n 23. See also Jacqueline Granados, 'Investor Protection and Foreign Investment under NAFTA Chapter 11: Prospects for the Western Hemisphere under Chapter 17 of the FTAA' (2005) 13 *Cardoza J Int'l & Comp L* 189. See also Gilbert Gagné and Jean-Frédéric Morin, 'The Evolving American Policy on Investment Protection: Evidence from Recent FTAs and the 2004 Model Bit' (2006) 9(2) *J Int'l Econ Law* 367.

<sup>166</sup> For Canadian perspectives on Ch 11, see, for example, Christopher Wilkie, 'The Origins of the NAFTA Investment Provisions: Economic Policy and Considerations'; J Anthony Van Duzer, 'NAFTA Chapter 11 to Date: The Progress of a Work in Progress'; Michael M Hart and William A Dymond, 'NAFTA Chapter 11: Precedents, Principles and Prospects'; and Maureen Appel Molot, 'NAFTA Chapter 11: An Evolving Regime' in *Whose Rights? The NAFTA Chapter 11 Debate*, *supra* n 8. See also <<http://www.naftalaw.org>>.

<sup>167</sup> On these developments, see, for example, Jürgen Kurtz, *supra* n 23.

so-called ‘Calvo Principle’ enshrining a simple conception of equality in relation to DFIs.<sup>168</sup> As practical measures, the United States sought full compensation for the expropriation of FDI; Mexico favoured protective investment legislation that resisted full compensation. Both based their different treatment towards FDI on public policy grounds.<sup>169</sup>

The specific task for the negotiators of Ch 11 of the NAFTA, not unlike the task of investment negotiators generally, was to find a balance between liberalising regional investment and protecting the right of host NAFTA countries to regulate FDI selectively in their ‘national interest’. The means chosen by the drafters to achieve this balance was both conceptual and functional. It was conceptual in applying well recognised international standards, such as the ‘most favoured nation’ and ‘national treatment’, to NAFTA investors. It was functional in applying substantive and procedural rules to the operation of such standards to promote the consistent yet equitable treatment of NAFTA investors. These conceptual and functional standards are comparable to those adopted elsewhere including in FTAs and BITs to which Australia is a party, not least of all, the AUSFTA.<sup>170</sup>

### xxviii. The Philosophy Governing Chapter 11

The primary vehicle for resolving investment disputes under the NAFTA is contained in Ch 11.<sup>171</sup> In addition, Art 2022 in Ch 20 encourages the use of international commercial arbitration to resolve NAFTA-related disputes generally.<sup>172</sup>

Chapter 11 straddles the divide between the liberalisation of DFI under the NAFTA and the conditions under which host countries may proscribe such investment.<sup>173</sup> Unlike most BITs, Ch 11 gives investors of NAFTA parties the choice to proceed under the banner of Ch 11 or

<sup>168</sup> Of particular relevance is the ‘Calvo Principle’, a construct of an Argentine politician which requires foreign investor disputes to be resolved before local courts rather than through international tribunals. For comments on the principle, somewhat from a United States perspective, see, for example, Donald Shea, *The Calvo Clause: A Problem of Inter-American and International Law and Diplomacy* (1955) 17–20; David Graham, ‘The Calvo Clause: Its Current State As A Contractual Renunciation of Diplomatic Protection’ (1971) 6 *Tex Int’l LJ* 289; Manuel R Garcia-Mora, ‘The Calvo Clause in Latin American Constitutions and International Law’ (1950) 33 *Marq L Rev* 205; Bernardo Cremades, ‘Disputes Arising Out Of Foreign Direct Investment in Latin America: A New Look at the Calvo Doctrine and Jurisdictional Issues’ (2004) 59 *Disp Resol J* 78. See also Romero Jimenez, ‘Considerations of NAFTA Chapter 11’ (2001) 2 *Chi J Int’l L* 243; Santiago Gonzalez-Luna, ‘Constitutional Challenges to NAFTA Chapter 11: American Perspective’ in Kennedy (ed), *The First Decade of NAFTA: the Future of Free Trade in North America* (2004).

<sup>169</sup> No doubt altruism plays a role in formulating and applying such philosophies to FDI. At core, however, each state views FDI from the perspective of its distinctive interests. See, for example, Draft, Negotiating Text, Chapter 11, <[http://www.ctrc.sice.oas.org/TPD/NAFTA/Chap11draft/41-FINAL\\_e.pdf](http://www.ctrc.sice.oas.org/TPD/NAFTA/Chap11draft/41-FINAL_e.pdf)>. But see *North American Free Trade Agreement, Notes of Interpretation of Certain Chapter 11 Provisions* (31 July 2001), NAFTA Free Trade Commission, <[http://www.ctrc.sice.oas.org/TPD/NAFTA/Commission/CH11understanding\\_e.asp](http://www.ctrc.sice.oas.org/TPD/NAFTA/Commission/CH11understanding_e.asp)>.

<sup>170</sup> See *infra* s 10.

<sup>171</sup> See Meg N Kinnear, Andrea K Bjorklund and John F G Hannaford, *Investment Disputes under NAFTA: An Annotated Guide to NAFTA Chapter 11* (2006).

<sup>172</sup> Article 2022 of the NAFTA provides: ‘1. Each Party, shall to the maximum extent possible, encourage and facilitate the use of arbitration and other means of alternative dispute resolution for the settlement of international commercial disputes between private parties in the free trade area’. Different formulations of arbitration are common among these options. On private arbitration options, see, for example, Thomas Carbonneau, ‘The Ballad of Transnational Arbitration’ (2002) 56 *U Miami L Rev* 773. A particular genre is state arbitration. See Carlos Garcia, *supra* n 73, at 477. One means of harmonising arbitration practice lies in reconciling differences in arbitration traditions, not limited to the common and civil law. See Leon E Trakman, ‘Legal Traditions and International Commercial Arbitration’ (2006) 17 *Am Rev Int’l Arb*.

<sup>173</sup> See, for example, Joel Trachtman, ‘The Domain of WTO Dispute Resolution’ (1999) 49 *Harv Int’l LJ* 333; Daniel Magraw, ‘NAFTA and the Environment: Substance and Process’, SB79ALI-ABA-117 (1997).

by resort to the domestic courts of the host country.<sup>174</sup> Investors can elect in light of the conduct of host countries, along with the perceived cost, duration, efficiency and fairness of proceeding.<sup>175</sup> In choosing arbitration under Ch 11, investors can select a distinctive mode of arbitration that is different from both traditional private arbitration as well as public arbitration between countries.<sup>176</sup>

Chapter 11 does not exclude other options. NAFTA parties can still invoke diplomatic measures against other countries, including under Ch 20 of the NAFTA.<sup>177</sup> Investors can also resort to traditional arbitration to resolve their disputes, an option encouraged under Art 2020 of the NAFTA.<sup>178</sup>

### **xxix. Construing Chapter 11**

The adoption of a distinctive investor-state system of dispute resolution under Ch 11 reflects a conscious abrogation of sovereignty by the NAFTA parties.<sup>179</sup> A public means of dispute resolution, Ch 11 proceedings diverge from both resort to domestic courts and private methods of arbitration.<sup>180</sup> There is also no supranational NAFTA body responsible to weigh human rights against other social considerations, a role played by the European Court of Human Rights (ECHR) among EU parties. Furthermore, Ch 11 tribunals are not bound by such jurisprudential doctrines as the ‘margin of appreciation’ doctrine developed by the ECHR to balance human rights against permissible social considerations<sup>181</sup> Again unlike

<sup>174</sup> See generally, Leon E Trakman, ‘Arbitrating Investment Disputes under Chapter 11 of the NAFTA’ (2001) 18 *J Int’l Arb* 385; Barton Legum, ‘The Innovation of Investor-State Arbitration under NAFTA’ (2002) 43 *Harv Int’l LJ* 53; Bradford K Gathright, *supra* n 98; William Dodge, *supra* n 98.

<sup>175</sup> See *infra* s 9v.

<sup>176</sup> See Robert E Lutz, ‘Current Developments in the NAFTA: A Guide for Future Economic Integration Efforts’ (1997) 18 *Whittier L Rev* 313; see also Cherie O’Niel Taylor, ‘Dispute Resolution as a Catalyst for Economic Integration and an Agent for Deepening Integration: NAFTA and Mercosur?’ (1996) 17 *NW J Int’l L Bus* 850 (analysing the impact of NAFTA’s dispute settlement systems on economic integration).

<sup>177</sup> On Art 2022 of the NAFTA, see *supra* n 172.

<sup>178</sup> See, for example, Leon E Trakman, ‘Arbitrating under Chapter 11 of the NAFTA: A Mexican Investor vs the US’ in *Doing Business in Mexico* (2002); Ari Afilalo, *supra* n 163, at 285. See also Jose E Alvarez, ‘Critical Theory and the North American Free Trade Agreement’s Chapter Eleven’ (1997) 28 *U Miami Inter-Am L Rev* 303.

<sup>179</sup> See generally, James R Holbein and Nick Ranieri, *North American Free-Trade Agreements: Chapter 11 Investor-State Arbitration* (2007); Ray C Jones, ‘NAFTA Chapter 11 Investor-to-State Dispute Resolution: A Shield to be Embraced or Sword to be Feared?’ (2002) *Brigham Young L Rev* 527; Gabriel Cavazos Villanueva and Luis F Martinez Serna, ‘Private Parties in the NAFTA Dispute Settlement Mechanisms: The Mexican Experience’ (2003) 77 *Tul L Rev* 1017; Jonathan I Miller, ‘Prospects for Satisfactory Dispute Resolution of Private Commercial Disputes Under The North American Free Trade Agreement’ (1994) 21 *Pepp L Rev* 1313; William D Merritt, ‘Practical Guide to Dispute Resolution Under The North American Free Trade Agreement’ (1999) 5 *NAFTA L & Bus Rev Am* 169.

<sup>180</sup> See Leon E Trakman, *supra* n 178; Ari Afilalo, ‘Towards a Common Law of International Investment: How NAFTA Chapter 11 Panels Should Solve their Legitimacy Crisis’ (2004) 17 *Georgetown Int’l Envir L Rev*; Matthew C Porterfield, ‘An International Common Law of Investor Rights?’ (2006) 27 *Int’l Econ Rev* 79.

<sup>181</sup> See further Elyse M Freeman, ‘Regulatory Expropriation under NAFTA Chapter 11: Some Lessons from the European Court of Human Rights’ (2003) 42 *Colum J Transnat’l L* 177; Helen Mountfield, ‘Regulatory Expropriations in Europe: The Approach of the European Court of Human Rights’ (2003) 11 *NYU Envir LJ* 136; Noemi Gal-Or, ‘Private Party Access: A Comparison of the NAFTA and the EU Disciplines’ (1998) 21 *BC Int’l & Comp L Rev* 1.

European Union law, Ch 11 decisions are not incorporated directly into the domestic law of the NAFTA parties.<sup>182</sup>

Chapter 11 is also subject to various ‘clarifications’ that are provided for in the text of the treaty. These include the judicial review of panel awards,<sup>183</sup> an Interpretive Note and Statement by the Free Trade Commission<sup>184</sup> and the passing of legislation in the United States, notably the Trade Act of 2002 (Trade Act).<sup>185</sup> Among other functions, these ‘clarifications’ purport to limit the authority of the United States Executive to negotiate treaties;<sup>186</sup> they also serve as a backdrop against which the United States has negotiated other BITs,<sup>187</sup> FTAs<sup>188</sup> and global agreements including the AUSFTA.<sup>189</sup>

There is no appeal from a Ch 11 NAFTA decision. The parties to an investment dispute have a limited right to review a Ch 11 award, including to correct errors in the award. Such review may take place before such international bodies as the ICSID, so long as the applicable NAFTA party is a signatory to the ICSID Convention.<sup>190</sup> Review may also take place before domestic courts of NAFTA partner countries. While a review is narrower in scope of application than a judicial appeal, the review of tribunal decisions under Ch 11 before the domestic courts of host NAFTA parties is common. Domestic courts ordinarily apply the law

<sup>182</sup> On the ‘margin of appreciation’ doctrine under EU Law, see, for example, Onder Bakircioglu, ‘The Application of the Margin of Appreciation Doctrine in Freedom of Expression and Public Morality Cases’ (July 2007) 8(7) *German L J*; Yuval Shany, ‘Toward a General Margin of Appreciation Doctrine in International Law’ (2005) 16 *Eur J Int’l L* 907; Eyal Benvenisti, ‘Margin of Appreciation, Consensus, and Universal Standards’ (1999) 31(4) *NYU Int’l J L & Pol* 843; R St J Macdonald, ‘The Margin of Appreciation’ in R St J Macdonald, F Mather and H Petzold (eds), *The European System for the Protection of Human Rights* (1993) 125–37.

<sup>183</sup> See *The United Mexican States v Metalclad Corporation*, 2001 BCSC 644 (Metalclad judgment); *The United Mexican States v Metalclad* (supplemental reasons), 2001 BCSC 1529 (Metalclad supplemental reasons); *The United Mexican States v Karpa: The Attorney-General of Canada, Respondent* (Intervenor), 70 OR (3rd) 180 (2005) (Feldman judgment); and *Attorney-General of Canada v SD Myers, Inc*, Court File No T-80-03 (Myers judgment).

<sup>184</sup> *Free Trade Commission Interpretive Note* (31 July 2001), <[http://www.dfait-maeci.gc.ca/tna-nac/nafta\\_commission-en.asp](http://www.dfait-maeci.gc.ca/tna-nac/nafta_commission-en.asp)> (Interpretive Note) and Statement of the FTC on Non-Disputing Party Participation (7 October 2003), <<http://www.dfait-maeci.gc.ca/nafta-alena/celeb2-en.asp>> (Statement of the FTC).

<sup>185</sup> See Trade Act of 2002, Pub L No 107–210, 116 Stat 933, 994 (2002) (Trade Act).

<sup>186</sup> See, for example, Dana Krueger, *supra* n 98; Jennifer Danner Riccardi, ‘The Failure of Chapter 19 in Design and Practice: An Opportunity for Reform’ (2003) 28 *Ohio NU L Rev* 727; Celine Levesque, *supra* n 155, at 323, nn 173–4. But see *contra*, Andrea J Menaker, ‘Benefiting From Experience: Developments in the United States’ Most Recent Investment Agreements’ (2005) 12 *UC Davis J Int’l L & Pol’y* 121.

<sup>187</sup> See, for example, 2004 US Model of Bilateral Investment Treat, <<http://www.state.gov/documents/organizations/29030.doc>> and <<http://www.state.gov/e/eb/rls/prsrl/2004/28923.htm>>. See also Canada’s Model Foreign Investment Promotion and Protection Agreement (FIPA), <[http://www.dfait-maeci.gc.ca/tna-nac/what\\_fipa-en.asp](http://www.dfait-maeci.gc.ca/tna-nac/what_fipa-en.asp)>. Chapter 11, arguably, is progressive when compared to most BITs, including those following the NAFTA, that deny such ex-post legislative and executive action.

<sup>188</sup> See Leon E Trakman, *The Proliferation of Free Trade Agreements*, *supra* n 69. Recent American FTAs include AUSFTA, signed 1 March 2004 (Annex 11-B); US-Chile FTA, signed 6 June 2003 (Annex 10-D); US-Central American Free trade Agreement (CAFTA), signed 28 January 2004 (Annex 10-C), including Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Dominican Republic; US-Morocco FTA, signed 15 June 2004 (Annex 10-B). See United States Trade Representative (USTR), <[http://www.ustr.gov/Trade\\_Agreements/Section\\_Index.html](http://www.ustr.gov/Trade_Agreements/Section_Index.html)>.

<sup>189</sup> On unsuccessful attempts to extend the purview of international investment law in the Doha Round, see *supra* n 42 and *infra* n 292. On the AUSFTAs, see *infra* s 10.

<sup>190</sup> On this right of review under the ICSID, ICSID Additional Facility and UNCITRAL Arbitration Rules, see *supra* s 7ii, d.

of the place of arbitration. However, they diverge over the applicable standards of review, the permissible discretion accorded to Ch 11 tribunals and the reasons for modifying or nullifying Ch 11 decisions. Such differences, particularly in the standards of review applied by domestic courts, give NAFTA investors an incentive to shop among the domestic courts of NAFTA parties in search of a sympathetic forum to ‘review’ Ch 11 decisions.<sup>191</sup>

The alternative, a second level of review within Ch 11, or a Ch 11 appellate process, has not evolved, although a case can be made for such a development.<sup>192</sup>

Investment decisions arising from the action of non-NAFTA parties may be subject to different kinds of appeal or review depending on the instruments governing them. From a comparative perspective, what is significant about the NAFTA is the extent to which the absence of a second level of review under Ch 11 has given rise to an eclectic mix of NAFTA jurisprudence on FDI.<sup>193</sup>

### xxx. Making Sense of Chapter 11

Chapter 11 is the subject of ongoing criticism. These criticisms are evaluated comparatively, including in relation to Australia and its investors abroad.

At the institutional level, NAFTA parties are criticised for invoking Ch 11 simultaneously to promote and undermine the liberalisation of FDI. The United States Government is criticised in particular for invoking Ch 11 unevenly,<sup>194</sup> promoting markets for its investors in other NAFTA countries while concurrently imposing regulatory measures to protect its domestic markets from investors of those countries.<sup>195</sup> Most controversial is the alleged shift by the United States from a staunch protector of liberalised FDI to erecting protective legal barriers against it.<sup>196</sup> Typifying this alleged shift are proposals that United States courts should be empowered to review Ch 11 awards and that arbitral decisions should be vacated for conflicting with United States law.<sup>197</sup> These controversies are most profound in relation to the

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<sup>191</sup> See J C Thomas, *supra* n 147; and Charles Brower, ‘NAFTA’s Investment Chapter: Initial Thoughts about Second-Generation Rights’ (2003) 36 *Vand J Transnat’l L* 153.

<sup>192</sup> See too Frederick Abbott, ‘The Political Economy of NAFTA Chapter 11: Equality Before the Law and the Boundaries of North American Integration’ (2000) 23 *Hasting Int’l & Compar Rev* 303. Abbott argues for a Ch 11 appellate tribunal composed of the Chief Justices of each NAFTA party, modelled to some extent on dispute resolution under Ch 20 of the NAFTA. But see William S Dodge, ‘Case Report: Waste Management, Inc v Mexico’ (2001) 95 *Am JIL* 186, who presents the case for modelling Ch 11 on the WTO appellate process. See also Jack J Coe, Jr, ‘Domestic Court Control of Investment Awards: Necessary Evil or Achilles Heel within NAFTA and the Proposed FTAA’ (2002) 19(3) *Journal of International Arbitration* 185; David A Gantz, ‘An Appellate Mechanism for Review of Arbitral Decisions in Investor-State Disputes: Prospects and Challenges’ (2006) 39 *Vand J Transnat’l L* 39.

<sup>193</sup> On that jurisprudence, see *infra* s 9v.

<sup>194</sup> On the United States’ alleged double standard in favouring resort to arbitration to restrain interference by foreign governments with private investment while disfavouring arbitration filed against United States Governments, see Guillermo Alvarez and William Park, ‘The New Face of Investment Arbitration: NAFTA Chapter 11’ (2003) 28 *Yale Int’l LJ* 365, 368–9.

<sup>195</sup> See generally Charles Brower and Lee Steven, ‘NAFTA Chapter 11: Who then Should Judge? Developing the International Rule of Law under NAFTA Chapter 11’ (2001) 2 *Chi J Int’l L* 193, 194–5; David A Gantz, *supra* n 192; Dana Krueger, *supra* n 98. See also Jack J Coe, Jr, *supra* n 192.

<sup>196</sup> See further *infra* s 9v, iii.

<sup>197</sup> For the proposal that Ch 11 arbitral awards be subject to review by the CIT in the United States, see S 3216 106th Cong (2000); see also, Gary Saxon House, ‘Dispute Settlement at the WTO and the Dole Commission: USTR Resources and Success’ in *Issues and Options for US-Japan Trade Policies* 363 (2002).

law governing the resolution of FDI disputes, not limited to NAFTA parties.<sup>198</sup> For example, the Australian Government must inevitably determine whether and to what extent to liberalise FDI including what constraints to impose upon that process of liberalisation in light of domestic political interests. Investors, in turn, need to anticipate those decisions when they engage in FDI.<sup>199</sup>

Controversial under Ch 11 is the absence of general exception clauses by which host NAFTA parties can shield themselves from investor challenges in relation to non-discriminatory regulatory measures. Varying markedly from the GATT that contained such non-discriminatory provisions,<sup>200</sup> NAFTA panels are called upon to differentiate between discriminatory and non-discriminatory measures. It is in investor challenges to countries determining whether measures are discriminatory that the judicial review of Ch 11 determinations is most profound, as occurred in *Loewen v US*<sup>201</sup> and *Methanex v US*.<sup>202</sup> In both cases, United States courts construed the regulatory practices of the United States expansively to legitimate allegedly discriminatory practices.<sup>203</sup> Again, both cases are relevant to FDI in Australia, including the manner in which investment tribunals, or domestic courts, may differentiate between discriminatory and non-discriminatory regulatory measures.

A further concern is that, rather than assess FDI on its merits, NAFTA governments may politicise the regulation of FDI. Instead of applying Ch 11 proactively, they may do so reactively in response to adverse domestic publicity, the costs of dispute resolution, the desire to avoid reprisals from other NAFTA parties and the hazard of losing FDI to competitors.<sup>204</sup> These concerns are germane to FDI in Australia. The Australian Government inevitably will want to balance its political and economic interests in FDI and the procedural and substantive protection it accords to foreign investors. Foreign direct investors need to determine the nature and impact of such political and economic interests upon them, quite apart from the legal fabric of a particular FTA or BIT in issue.<sup>205</sup>

A justification for the United States and Canada negotiating Ch 11 was to impede Mexican courts from invoking constitutional measures to regulate foreign investment or to expropriate

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<sup>198</sup> See generally J Anthony Van Duzer, *supra* n 166.

<sup>199</sup> See generally *infra* s 10.

<sup>200</sup> On such measures in the GATT, see, for example, *supra* n 78.

<sup>201</sup> On *Loewen*, see *supra* n 98.

<sup>202</sup> On *Methanex*, see *supra* n 139. See also William T Warren, 'Paying to Regulate: Guide to *Methanex v United States and the NAFTA Investor Rights*' (2001) 31 *Environmental Rep* 10986.

<sup>203</sup> For criticism of the *Loewen* litigation and decision, see, for example, Ari Afilalo, *supra* n 180. ('In *Loewen*, the tribunal was presented with a straightforward application of denial of justice concepts. The trial was botched so badly that any reader of its transcripts could not help but recall the proverbial "kangaroo court". The defendant corporation was targeted specifically because of its nationality. It withstood a huge verdict wholly disproportionate to the actual harm committed. Its appeals were not accepted, and in the end, *Loewen* was forced to settle under duress. However, any arbitral panel would have found it difficult to rule against the United States, even given the facts of the case. The US justice system is known for aberrations such as the one that occurred in Mississippi, and they are part of America's social, cultural and institutional fiber. The combination of punitive damages, a runaway jury, and a pro-plaintiff judge is not an unusual one in this country. The outcry against the *Loewen*-NAFTA litigation, and the vigor of the defence mounted by the Justice Department, signaled to the tribunal that the case touched a nerve with many of the powers-that-be': p 27.)

<sup>204</sup> The *Myers* litigation is sometimes treated as exemplifying this problem. See *supra* nn183, 220, 221.

<sup>205</sup> On consideration of these issues by the Australian Government, see OECD Investment Committee, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

in the absence of ‘adequate’ compensation.<sup>206</sup> A profound concern today is that the United States is ready to invoke constitutional measures to protect its domestic political, social and economic interests. A comparable concern is whether the Australian Government might follow suit, shifting from measures directed at trade liberalisation to measures directed at trade protectionism. Even more pertinent for Australian investors abroad is whether Australia’s FTA and BIT partners in the region or internationally might display even greater ambivalence towards investment liberalisation at an uncertain future date, usually after an FDI commitment has been made.<sup>207</sup>

The mechanisms for resolving Ch 11 disputes are also relevant to the resolution of FDI disputes in Australia. Chapter 11’s distinctive mechanisms for resolving investor-state disputes sought to avoid domestic courts that might lack expertise in FDI and that might respond to foreign investor rights selectively in light of local public policy.<sup>208</sup> A collateral concern is that FTAs and BITs to which Australia is a party may incorporate judicial mechanisms for dispute resolution that refer disputes to domestic courts; that those domestic courts may be unduly responsive to domestic interests and conceivably, may lack the requisite FDI expertise. These concerns may relate less to the capacity and resolve of Australian courts charged with FDI jurisdiction than to the dispute resolution capacity and resolve of domestic courts in its investment partners.<sup>209</sup>

The perceived virtues of Ch 11 are also their source of weaknesses. A rationale in support of Ch 11 is to establish a balance between investor rights and domestic economic, labour and environmental interests. A comparable fear is that FTAs and BITs to which Australia is — or becomes — a party, rather than accommodate FDI interests, may repress them in the interests of domestic political, social and economic interests.<sup>210</sup>

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<sup>206</sup> See, for example, Charles Brower, *supra* n 191; William Michael Treanor, ‘The Original Understanding of the Takings Clause and the Political Process’ (1995) 95 *Colum L Rev* 782; J Peter Byrne, ‘Ten Arguments for the Abolition of the Regulatory Takings Doctrine’ (1995) 22 *Ecology LQ* 89; Matthew P Harrington, ‘“Public Use” and the Original Understanding of the So-Called “Takings” Clause’ (2002) 53 *Hastings LJ* 1245; Gavin M Erasmus, ‘Eminent Domain Jurisprudence’, C791 ALI-ABA 1 (1993); Frederick Abbott, ‘The Political Economy of NAFTA Chapter Eleven: Equality Before the Law and the Boundaries of North American Integration’ (2000) 23 *Hastings Int’l & Compar L Rev* 303.

<sup>207</sup> On policies considered by the Australian Government in the liberalisation of investment within APEC in particular, see <[http://www.firb.gov.au/content/international\\_investment/apec.asp](http://www.firb.gov.au/content/international_investment/apec.asp)>.

<sup>208</sup> This was the perception of the Loewen case. See *supra* n 98

<sup>209</sup> This does not suggest that international investment tribunals are invariably expert, while domestic courts are not. Rather, what is suggested is that, all other factors being constant, domestic courts may have a greater incentive to decide in accordance with domestic public policy than international investment tribunals.

<sup>210</sup> For discussion of these issues, see Leon E Trakman, ‘Rethinking International Environmental Rights and Responsibilities: The Mexican Experience’ (with Sean Gatién) in *Doing Business in Mexico* (2003); David Gantz, ‘Potential Conflicts Between Investor Rights and Environmental Regulation Under NAFTA Chapter 11’ (2001) 33 *Geo Wash Int’l L Rev* 651; David A Gantz, ‘Reconciling Environmental Protection and Investor Rights Under Chapter 11 of the NAFTA’ (2001) 31 *Env’tl L Rep* 10646; Kal Raustiala, ‘The Political Implications of the Enforcement Provisions of the NAFTA Environmental Side Agreement: The CEC as a Model for Future Accords’ (1995) 25 *Env’tl L Rep* 31; Jeffery Atik, ‘Environmental Standards Within NAFTA: Difference by Design and the Retreat from Harmonization’ (1995) 3 *Ind J Global Leg Stud* 81; Paul Stanton Kibel, ‘Awkward Evolution: Citizen Enforcement at the North American Environmental Commission’ (2002) 32 *Env’tl L Rep* 10769; Robert F Houseman, ‘The Treatment of Labor and Environmental Issues in Future Western Hemisphere Trade Liberalization Efforts’ (1995) 10 *Conn J Int’l L* 301.

### xxxi. Standard of Treatment and Performance Requirements

Particularly germane to Australia and its FTA and BIT partners are the standards of treatment to be accorded to foreign direct investors.

Chapter 11 of the NAFTA establishes four standards of treatment to be accorded to NAFTA investors: national treatment; most-favoured-nation treatment; standard of treatment; and minimum standards of treatment.<sup>211</sup> The requisite standard for the ‘fair and equitable treatment’ of investors is embodied in Art 1105; it is distinctive and is not a distillation of other treaty-based guarantees such as national and most favoured nation (MFN) treatment.<sup>212</sup> These standards are significant to non-NAFTA countries like Australia that adopt comparable language in their FTAs and BITs as well as foreign direct investors who are regulated by such standards under an applicable FTA or BIT to which Australia is a partner.<sup>213</sup>

Chapter 11 imposes performance requirements on NAFTA parties that might otherwise diminish the value of FDI.<sup>214</sup> These requirements serve as a potential template to the requirements imposed by non-NAFTA parties upon foreign investors, including Australia.

Performance requirements under Ch 11 include prohibiting NAFTA member countries from: tying sales to foreign exchange earnings; insisting that investors buy local products and services; requiring a minimum of local content; requesting foreign exchange inflows; demanding technology transfers other than corrective anti-competitive measures; demanding technology transfers to local companies in particular; requiring specific levels of goods or services; and requiring that foreign markets be supplied from local production.<sup>215</sup> NAFTA member countries are also required to permit the free and uninterrupted transfer of investments at prevailing market rates of exchange.<sup>216</sup>

These performance requirements are also subject to the right of a NAFTA party to impose special formal and disclosure requirements on NAFTA investors. However, these requirements may not materially impair the requisite protection accorded foreign investors and requirements imposed on NAFTA parties under Ch 11, including the equitable and good faith application of each Party’s law.<sup>217</sup>

It remains to be seen how domestic courts or investment tribunals among Australia’s FTA or BIT actual or prospective partners might construe such performance requirements, what legal attributes they might attribute to them, and how their application of those standards might accord with fair and equitable treatment in fact.

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<sup>211</sup> Chapter 11 provides for these standards in Art 1102 (national treatment); Art 1103 (most-favoured-nation treatment); Art 1104 (standard of treatment); and Art 1105 (minimum standard of treatment); see further Todd Wieler, ‘The Potential For Overlap in NAFTA Chapter 11 Obligations’ in Kevin Kennedy (ed), *The First Decade of NAFTA: The Future of Free Trade in North America* (2004).

<sup>212</sup> See *supra* 8ii(a). See generally Christoph Schreuer, *supra* n 74; Stephen Vasciannie, *supra* n 147; J C Thomas, *supra* n 147; Barnali Choudhury, *supra* n 147; Courtney Kirkman, *supra* n 147; Patrick Dumbery, *supra* n 147.

<sup>213</sup> On different investment agreements that Australia has or is currently negotiating, see *supra* n 1.

<sup>214</sup> See NAFTA Art 1106.

<sup>215</sup> See NAFTA Ch 11 Art 1106 (1)(a–g) (performance requirements).

<sup>216</sup> See NAFTA Ch11 Art 1109 (transfers).

<sup>217</sup> See NAFTA Art 1110(1)–(2).

**xxxii. Placing Restrictions on State Powers**

Restrictions on state powers under the NAFTA also serve as a template for restrictions imposed by non-NAFTA parties upon foreign investors.

NAFTA countries are prohibited from imposing national requirements on investors of other NAFTA member countries that are not imposed on that country's own nationals.<sup>218</sup> Illustrating this requirement, the *Pope & Talbot* tribunal held that a measure is a 'requirement' only if it has a mandatory character which requires particular investor behaviour.<sup>219</sup> NAFTA countries are specifically prohibited from placing transfer restrictions on investors, except where they are equitable, non-discriminatory and constitute good faith in compliance with its laws.<sup>220</sup>

Particular germane to non-NAFTA countries like Australia are Ch 11's expropriation measures. These measures are especially controversial in respect to 'indirect expropriation' and measures 'tantamount to expropriation'. On the one hand is the view that expropriation ought to be limited to governmental regulations that are clearly not discriminatory, and reasonable under international law.<sup>221</sup> On the other hand is the opinion that provisions on expropriation ought to be construed expansively to exclude protective measures that constitute indirect expropriations.<sup>222</sup>

Another issue raised is the appropriate limits on the power of governments to act in the public interest in the exercise of state sovereignty and when such action is 'tantamount to expropriation' which is compensable. Arriving at decisions concerning whether governmental regulations constitute legitimate acts of expropriation can be complicated by imprecise language that is used to describe both expropriation and compensation. Such is the case in the case law under Ch 11 of the NAFTA.<sup>223</sup>

Determining the nature and limits of action 'tantamount to expropriation' is likely to arise before investment tribunals and courts appointed under one or another BIT or FTA to which Australia is or becomes a party. Reaching such a determination will inevitably depend on a combination of the treaty language used to delineate such an expropriation, the reasons given

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<sup>218</sup> See NAFTA Art 1107(1), (2).

<sup>219</sup> See *Pope & Talbot, Inc v Canada*, Interim Merits Award, 26 June 2000 (2001) 40 *ILM* 258 (Pope and Talbot, Interim Merits Award); and *Pope & Talbot, Inc v Canada*, NAFTA/UNCITRAL Tribunal, Final Merits Awards, 10 April 2001, <<http://www.naftalaw.org>>.

<sup>220</sup> See NAFTA Art 1109. Chapter 11 tribunals have construed these requirements restrictively to situations in which requirements are mandatory and compel the investor's behaviour. See *SD Myers Inc v Canada*, NAFTA/UNCITRAL Tribunal, Partial Award, 13 November 2000, (2001) 40 *ILM* 1408, <<http://www.naftalaw.org>> (Myers) and (Myers Dissent).

<sup>221</sup> See Jason Gudofski, 'Shedding Light on Article 1110 of the NAFTA Concerning Expropriations: An Environmental Case Study' (2000) 21 *NW J Int'l L & B* 243; J Anthony Van Duzer, *supra* n 166.

<sup>222</sup> Such protective measures are noticeable in relation to the environment. See, for example, J Martin Wagner, 'International Investment, Expropriation and Environmental Protection' (1999) 29 *Golden Gate UL Rev* 465.

<sup>223</sup> But see Todd Weiler, 'NAFTA Chapter 11 Jurisprudence: Coming Along Nicely' (2003) 9 *SW JL & Trade in the Americas* 245, 337; Todd Weiler, 'NAFTA Investment Arbitration and the Growth of International Economic Law' (2002) 36 *Can Bus LJ* 405.

to support or deny the governmental measure and its perceived effectiveness and fairness to investors.<sup>224</sup>

### xxxiii. Leading Chapter 11 Cases

NAFTA jurisprudence is pertinent to Australia and its investors in delineating the power of host countries to expropriate, the grounds for doing so and the consequences of such action including the nature and extent of compensation required.

There are a limited number of Ch 11 cases.<sup>225</sup> Key among these is *Methanex*,<sup>226</sup> *Metalclad*,<sup>227</sup> *Feldman*,<sup>228</sup> *Ethyl*,<sup>229</sup> *Pope & Talbot*,<sup>230</sup> *Myers*,<sup>231</sup> *Ethyl*,<sup>232</sup> and *Thunderbird*.<sup>233</sup> Most Ch 11 cases deal with Art 1110 on direct and indirect government takings.<sup>234</sup> However, a few clarify the international investment law governing the nature and limits of an 'expropriation'. Those that provide substantive content and meaning to an 'expropriation' are treated as authoritative on the one hand, while sometimes doubted as being too open-ended or, conversely, too closed-ended on the other.

For example, in finding a breach of Art 1110 on expropriation,<sup>235</sup> the *Metalclad* tribunal defined the taking of property, not only as 'outright seizure or formal or obligatory transfer of title in favour of the host state', but also as 'covert or incidental interference with the use of property' which has the effect of 'depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state'.<sup>236</sup> While this expansive conception of an expropriation may be doubted for being unduly open-ended,<sup>237</sup> it is sometimes cited as an authority on the limits of expropriation.<sup>238</sup>

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<sup>224</sup> Much will depend on the language adopted by a particular FTA or BIT to which Australia is a party and the court or tribunal interpreting it. See generally *supra* n 1 on FTAs and BITs to which Australia is an actual or prospective party.

<sup>225</sup> On claims under the NAFTA, see <<http://www.naftaclaims.com>>.

<sup>226</sup> *Methanex Corporation v United States* (Methanex), <<http://www.naftaclaims.com>>. See also John R Crook, 'NAFTA Tribunal Rules in US Favour in Methanex Case' (2002) 99 *Am J Int'l L* 920.

<sup>227</sup> *Metalclad Corp v United Mexican States*, Final Award, NAFTA/ICSID (AF) Tribunal, Case No ARB(AF)/97/1, 30 Aug 2000, (2001) 40 *ILM* 36 (*Metalclad*).

<sup>228</sup> See *Marvin Feldman v Mexico*, ICSID Case No ARB (AF)/99/1 at 70 (16 Dec 2002) (*Feldman*), <[http://www.worldbank.org/icsid/cases/feldman\\_mexico-award-en.PDF](http://www.worldbank.org/icsid/cases/feldman_mexico-award-en.PDF)>.

<sup>229</sup> See *Ethyl Corp v Canada*, Award on Jurisdiction, NAFTA /UNCITRAL Tribunal, 24 June 1998.

<sup>230</sup> See *Pope & Talbot, Inc v Canada*, Interim Merits Award, 26 June 2000, (2001) 40 *ILM* 258 (Pope & Talbot, Interim Merits Award) and *Pope & Talbot, Inc v Canada*, NAFTA/UNCITRAL Tribunal, Final Merits Awards, 10 April 2001, <<http://www.naftalaw.org>>.

<sup>231</sup> See *SD Myers Inc v Canada*, NAFTA/UNCITRAL Tribunal, Partial Award, 13 November 2000, (2001) 40 *ILM* 1408, <<http://www.naftalaw.org>> (Myers) and (Myers Dissent); *Attorney-General of Canada v SD Myers, Inc*, Court File No T-80-03 (Myers judgment).

<sup>232</sup> See *Ethyl Corporation and the Government of Canada*, Notice of Arbitration filed 14 April 1997. Documents pertaining to this case are available at <<http://www.naftalaw.org>>.

<sup>233</sup> See *International Thunderbird Gaming Corporation and the United Mexican States* (Thunderbird), (UNCITRAL Arbitration Rules, 26 Jan 2006) <<http://www.naftaclaims.com>>.

<sup>234</sup> On Ch 11 claims under the NAFTA, see <<http://www.naftaclaims.com/>>.

<sup>235</sup> *Metalclad*, *supra* n 227.

<sup>236</sup> *Ibid* at para 103.

<sup>237</sup> *Mexico v Metalclad*, 2001 BCSC 664 and supplemental reasons, 2001 BCSC 1529, <<http://www.dfait-maeci.gc.ca/tna-nac/documents/trans-2may.pdf>>. See Celine Levesque, *supra* n 155; J C Thomas, 'The Experience of NAFTA Chapter 11 Tribunals to Date: A Practitioner's Perspective' in *Whose Rights: the NAFTA Chapter 11 Debate*, *supra* n 8. See, for example, *Pope & Talbot*, Interim Merits Award. See also, *Marvin*

Other Ch 11 cases have taken a restrictive view of an expropriation under Art 1110.<sup>239</sup> For example, the tribunal in *Pope & Talbot*, after identifying ‘creeping expropriation’,<sup>240</sup> insisted that ‘confiscatory’ action is contrary to Art 1110 when it ‘prevents, unreasonably interferes with or unduly delays, effective enjoyment of an alien’s property’.<sup>241</sup> In holding against the investor, the *Pope and Talbot* tribunal concluded that the government regulation fell short of a ‘taking’ and the investor, in continuing to operate a profitable business, had not suffered a substantial loss of control over that business as a result of the government regulation.<sup>242</sup>

The *Myers* tribunal also conceived of an expropriation restrictively. In order to satisfy the requirement of an ‘expropriation’, there needed to be ‘a lasting removal of the ability of an owner to make use of its economic rights ... even if it were partial or temporary’.<sup>243</sup>

The *Feldman* tribunal elaborated on this restrictive conception of an expropriation by drawing a distinction between an expropriation contrary to Art 1110 and a regulation falling short of an expropriation.<sup>244</sup> Drawing on the *Azinian* decision,<sup>245</sup> the *Myers* tribunal commenced with the cautionary comment: ‘[N]ot all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business ... is an expropriation under Article 1110’.<sup>246</sup> It added that ‘[g]overnments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue’; but they do not necessarily constitute acts of expropriation.<sup>247</sup> In deciding that the government’s actions fell short of an expropriation, the *Feldman* tribunal declined to consider that the government had violated the public purpose, non-discriminatory and due process criteria in Art 1110; but it did consider whether it had violated the minimum standards of treatment.<sup>248</sup>

Both the *Pope & Talbot* and *Feldman* tribunals held that, for a government to substantially interfere with an investment sufficient to constitute a confiscation, such interference needed to impact on the investor’s business as a whole, as distinct from only a part of it.<sup>249</sup>

*Feldman v Mexico*, ICSID Case No ARB (AF)/99/1 at 70 (16 Dec 2002) (*Feldman*), <[http://www.worldbank.org/icsid/cases/feldman\\_mexico-award-en.PDF](http://www.worldbank.org/icsid/cases/feldman_mexico-award-en.PDF)>.

<sup>238</sup> See, for example, Todd Weiler, *NAFTA Chapter 11 Jurisprudence: Coming Along Nicely*, *supra* n 223, at 325 (an optimistic view that Ch 11 jurisprudence is increasingly comprehensible).

<sup>239</sup> On Art 1110 of the NAFTA, see Kevin Banks, ‘NAFTA’s Article 1110: Can Regulation be Expropriation?’ (1999) 5 *NAFTA L & Bus Rev Am* 499, 508–9.

<sup>240</sup> Defined as government taking that ‘could be conducted by regulation and a blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation’. See *Pope & Talbot*, Interim Merits Award, *supra* n 219, at para 99. See also Louis B Sohn and R R Baxter, *supra* n 3 (noting Harvard’s Draft Convention on the International Responsibility of States for Injuries to Aliens).

<sup>241</sup> *Pope & Talbot*, *ibid*, at para 102.

<sup>242</sup> *Ibid* at paras 96–114.

<sup>243</sup> *Ibid* at para 283.

<sup>244</sup> *Feldman*, *supra* n 237, at para 100.

<sup>245</sup> See, for example, *Azinian et al and The United Mexican States*, Notice of Arbitration, filed 10 March 1997, Final Award, 1 November 1999, <<http://www.naftalaw.com>>. For documents filed in this case, see <<http://www.naftalaw.org>>. See also Sean Murphy, ‘NAFTA Waste Management Tribunal Finds No Arbitrary Issue, No Expropriation’, 98 *Am J Int’l L* 838.

<sup>246</sup> *Feldman* at para 112.

<sup>247</sup> *Ibid* at paras 112, 135.

<sup>248</sup> *Ibid* at para 141. See also Todd Weiler, ‘NAFTA Chapter 11 Jurisprudence: Coming Along Nicely’ *supra* n 223, at 350.

<sup>249</sup> *Feldman*, *supra* n 237, para 152. *Pope and Talbot*, *supra* nn 219, paras 96–114.

In identifying sources of law to justify a finding of a ‘government taking,’ Ch 11 tribunals have relied significantly on United States domestic law, treating it as part of international law.<sup>250</sup> For example, both *Pope & Talbot* and *Feldman* drew heavily on the United States Restatement Second and in the case of *Feldman*, the Harvard Draft,<sup>251</sup> and the umbrella provisions of Fifth and Fourteenth Amendments of the United States Constitution.<sup>252</sup> Even though United States law is part of international law, problems arise in attributing a weight to that law when it diverges from ‘other’ international law on the nature and limits of an expropriation.<sup>253</sup> Comparable concerns arise in determining the weight to be accorded to the domestic law of Australia in governing a ‘government taking’, including the relationship between that law and international investment law.<sup>254</sup>

What is relevant to Australian FDI is the absence of a consistent jurisprudence governing the nature and limits of an expropriation under Ch 11. For example, even though Ch 11 tribunals reasonably consistently require that an expropriation occurs only when governmental interference is ‘substantial’ it is still unclear how much interference is substantial in fact. On a narrower view, substantial interference ought to be construed restrictively in deference to the police powers of NAFTA parties and their right to regulate property rights. On a wider view of substantial interference, investment tribunals ought to take full account of both the kind and degree of government regulation in determining whether to treat a ‘taking’ as unjustified interference.<sup>255</sup>

If courts and tribunals, among Australia’s actual or prospective FTA and BIT partners, decide investment cases based on the kind or *genus* of an expropriation, their analysis will inevitably invite normative discourse into different kinds of state action that ought to be permitted. If they ground their determinations in the degree of governmental interference, they will invite debate over the spectrum of governmental action that is legitimate. The problem is that their deciding on the basis of either the kind or degree of a ‘government taking’ may be construed differently from case to case in light of variations in philosophical and functional values. Such variations can also give rise to uncertainty over the parameters of a legitimate ‘government taking’. These problems, apparent under the NAFTA, are likely to arise under other investment regulatory regimes including those adopted by Australian and its FTA and BIT partners.<sup>256</sup>

In summary, Ch 11 jurisprudence is worryingly inconsistent. Some Ch 11 tribunals have avoided relying on specific provision governing direct and indirect expropriation, namely, under Art 1110. They have preferred to ground their decisions on Art 1105 on fair and

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<sup>250</sup> The ICJ Statute Art 38(d) refers to ‘the teachings of the most highly qualified publicists of various nations’ to help determine the rules of law: <<http://www.icj-icj.org/cijwww/cdocumentbase/cba-sictext/cbasicstatute.html>>. See also Celine Levesque, *supra* n 155, at 303–4.

<sup>251</sup> See Celine Levesque, *supra* n 155, at 303–4.

<sup>252</sup> *Ibid* at 304.

<sup>253</sup> *Ibid*.

<sup>254</sup> For a submission raising such issues, see, for example, John Rutherford, *Australia-United States Free Trade Agreement (FTA), Submission to the Senate Select Committee*, 28 April 2004, <[http://www.aph.gov.au/senate\\_freetrade/submissions/sub269.pdf](http://www.aph.gov.au/senate_freetrade/submissions/sub269.pdf)>.

<sup>255</sup> See, for example, Rutherford, *ibid*.

<sup>256</sup> On the Australian Government’s recognition of these and related problems, see, for example, *Investment for Development — Policy Framework for Investment (PFI)*, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

equitable treatment.<sup>257</sup> Other Ch 11 tribunals have based their decisions on a breach of contract by a local authority, as distinct from a ‘government taking’.<sup>258</sup> Most tribunals that have relied on Art 1110 have construed an expropriation restrictively, requiring a high degree of interference to constitute an expropriation. This restrictive conception of an expropriation is most evident in the *Myers* decision, in differing between expropriations that ‘tend to involve the deprivation of property rights’ and regulations that ‘amount to a lesser interference’.<sup>259</sup>

A warning signal to non-NAFTA parties like Australia and its FTA and BIT partners lies in arriving at substantive reasons for distinguishing between legitimate regulation and arbitrary ‘takings.’ A further concern is over the legal significance that domestic courts or investment tribunals ought to be accorded to different kinds and degrees of regulations governing such takings. Complicating these decisions is the need for courts or tribunals to consider the source of law through which an expropriation is determined, the extent to which that source derives from domestic law, customary international law and multilateral and bilateral treaties.<sup>260</sup>

#### xxxiv. Putting Chapter 11 into a Comparative Perspective

Chapter 11 jurisprudence has not enjoyed an easy rite of passage. A macro-political critique of the NAFTA, not limited to Ch 11, is that it was negotiated by the Executive of the three NAFTA member countries and that such negotiations by the Executive were undemocratic and usurped the powers of the legislative arm of government.<sup>261</sup> Chapter 11 is also challenged as an undesirable template for replication in other regional agreements.<sup>262</sup>

Chapter 11 decisions are also criticised for providing greater benefits to investors from capital-exporting NAFTA countries than capital-importing ones, in effect protecting United States and Canadian investment interests above Mexican interests.<sup>263</sup> It is true that there are more Ch 11 proceedings involving Canadian and United States investors than Mexican

<sup>257</sup> See *The Loewen Group, Inc and Raymond L Loewen v United States of America*, *supra* nn 93, 208. In that case, the tribunal dismissed the expropriation claim against the United States Government.

<sup>258</sup> See *Azinian*, *supra* n 245. In this case, the tribunal declined to treat a breach of contract as an expropriation.

<sup>259</sup> *Myers*, *supra* n 183, para 282. See too *supra* text accompanying nn 220, 231.

<sup>260</sup> Such uncertainty is most likely under Australia’s most far-reaching free trade agreement with the United States, particularly in determining the nature and limits of a direct and indirect expropriation under Ch 11, as well as in determining exceptions to Ch 11 on grounds, *inter alia*, of national interest and public welfare. See further *infra* s 10.

<sup>261</sup> See, for example, Jeffery Attie, ‘Legitimacy, Transparency and NGO Participation in the NAFTA’S Chapter 11 Process’ in Todd Weiler (ed), *NAFTA Investment Law and Arbitration: Past Issues, Current Practice, Future Prospects* (2004) 138 (on the absence of democratic negotiation in the development of Ch 11). But *cf* Thomas Carbonneau, *supra* n 172, at 826–8 (that, even though the creation and application of Ch 11 may appear not to be democratic, Ch 11 is an effective measure in regulating modern trans-border commerce).

<sup>262</sup> Some regional FTAs concluded directly after the NAFTA replicate parts of its investor provisions, particularly in regard to safeguard protection. See, for example, The Canada-Chile FTA, concluded 5 Dec 1996, reprinted in (1997) 36 *ILM* 1067, 1114; and the Mexico-Northern Triangle FTA, in Guillermo Pereira, ‘Mexico-Northern Triangle Free Trade Agreement’ (2001) 7 *L & Bus Rev Am* 383. More recent regional agreements, such as the CAFTA and the US-Chile FTA, are distinct from the NAFTA, and this trend away from the NAFTA’s safeguard provisions is likely to continue. See David Gantz, ‘The Evolution of FTA Investment Provisions: From NAFTA To The United States-Chile Free Trade Agreement’ (2004) 19 *Am U Int’l L Rev* 679.

<sup>263</sup> Claims brought against United States and Canadian Governments represent a greater share of investment capital than claims against the Mexican Government. American and Canadian investors also incur significant costs in bringing NAFTA claims under Ch 11, which sometimes are unsuccessful. See generally *supra* nn 163, 165, 167, 215. See also, Jose E Alvarez, ‘Critical Theory and the North American Free Trade Agreement’s Chapter 11’ (1997) 28 *U Miami Inter-Am L Rev* 303.

investors, but that is understandable given the larger capital markets in those countries than in Mexico.<sup>264</sup> It is also questionable whether Mexican interests have borne the brunt of adverse Ch 11 decisions: the evidence suggests to the contrary.<sup>265</sup> A parallel concern may be that Australia needs to carefully choose its investment partners, including a consideration of their investment proclivities, and the potential for tension to arise on account of differences in such proclivities to our own.<sup>266</sup>

Particular criticism is directed at Ch 11's terms of reference governing the appointment of investment tribunals; the inconsistent interpretations that different tribunals accord to Ch 11; and the costs of Ch 11 proceedings.<sup>267</sup> Such inconsistencies are also likely to arise under FTAs and BITs concluded between Australia and its various partners.<sup>268</sup>

Australia can also expect that some of its FTAs and BITs may enjoy an easy rite of passage only to be embroiled on controversy over the perceived conflict between national and investment interest. Typifying this controversy is the fact that Ch 11 is marred by repeated calls for its repeal and consternation over the millions of dollars of damages awarded to foreign nationals in sensitive areas like the environment.<sup>269</sup> Counted among its critics from time to time are the United States Congress,<sup>270</sup> powerful lobby groups and academics, especially in the United States, who are worried about the cost of protective barriers erected against foreign investors and the filtration of millions of tax-payer dollars to successful foreign claimants.<sup>271</sup> As Australia extends its FTA and BIT partnerships, it may face comparable controversies.

Equally importantly, however carefully FTAs and BITs may be negotiated and drafted, they may still lack the requisite clarity. Typifying such lack of clarity are the diverse interpretations accorded to Ch 11. FTA and BIT partners may try to clarify differences over the nature and limits of expropriation, national treatment, fair and equitable treatment, and consultation among the partner countries, not unlike the efforts of the NAFTA parties. At the same time, it is important to recognise that treaty provisions like Ch 11 of the NAFTA

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<sup>264</sup> An overriding issue is the perceived inequality between investors from developed states like the United States and Canada and developing countries like Mexico, which is accentuated by the use of the NAFTA in a manner that conflicts with select equality rights under the Mexican Constitution. See, for example, Cesar De La Garza, 'Constitutional Inconsistencies of NAFTA Chapter 19: A Mexican Perspective' in Trakman, Ranieri and Lopez (eds), *Doing Business in Mexico* (1998–2006).

<sup>265</sup> Interestingly, Canada has become the target of a series of recent challenges from primarily United States investors arising primarily from Canada's environmental protection regulation. See, for example, <<http://www.policyalternatives.ca/Reports/2008/01/ReportsStudies1814/>>.

<sup>266</sup> On the Australian Government's appreciation of these risks, see *Current International Investment Issues*, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>267</sup> See further Ari Afilalo, *supra* n 187.

<sup>268</sup> The Australian Government, in recognition of these risks, has set up a committee to analyse them: see *Analysis of Key Obligations and Emerging Issues in International Investment Treaties*, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>269</sup> See 'North American Agreement on Environmental Cooperation, US Can Mex' 321 *LM* 1482 (NAEEC). See also J Martin Wagner, *supra* n 222.

<sup>270</sup> On calls in the United States Congress for the repeal of the NAFTA, see 107 Cong Rec S4594 (21 May 2002).

<sup>271</sup> This concern is most pronounced following the Ch 11 arbitration in the *Methanex* case. See further *supra* n 139.

anticipate ongoing interpretation, including the prospect of controversy over its application to particular cases.<sup>272</sup>

Recent events, including statements by United States President-elect Barak Obama, have lent credence to the prospect that the NAFTA will be renegotiated. This probability is accentuated in the current financial crisis, as is concern that FDI incursions into the United States, aided by Ch 11 of the NAFTA, conflict with, more than they support, United States domestic interests.<sup>273</sup> Again, the prospects of investment agreements between Australia and its FTA and BIT partners may be subject to the ebb and flow of political and economic dynamics, not least of all due to ascending or descending political and economic alliances within a constantly changing global investment climate.<sup>274</sup>

What lessons might Australia and its investors learn from Ch 11 of the NAFTA? In fairness, one ought not to expect too much from Ch 11 jurisprudence. A past-generation trade and investment treaty peculiar to the North American environment, Ch 11 attempts to balance the competing interests of the United States and Canada as capital exporters with an established albeit impaired history of investment liberalisation against the interests of Mexico as a capital importer with an early history of investment confiscation.<sup>275</sup> Australia inevitably faces somewhat comparable issues in concluding investment treaties, not least of all in its region. What it may learn from the NAFTA is that negotiated investment treaties, like contracts generally, may have a limited shelf life. Negotiated provisions governing an expropriation, suitable at one moment of time in relation to one or more parties, may be ill suited at another moment or in relation to other parties.<sup>276</sup>

Countries that broker distinctive dispute resolution mechanisms in their treaties, whether through their courts or investment tribunals, cannot be assured that such decisions will suit either them or their investors in partner countries. In a world imperilled by global financial crises, arriving at principled and consistent investment decisions, at the very least, will be challenging, however adept investment tribunals or courts might be in deciding specific cases.<sup>277</sup>

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<sup>272</sup> Some Canadians have echoed this sentiment. See *Canadian Memo on Investor-State Provisions* (13 November 1998), <[http://www.insidetrade.com/sec-i/as\\_web.exe?SEC\\_IT1999+D+1750780](http://www.insidetrade.com/sec-i/as_web.exe?SEC_IT1999+D+1750780)>.

<sup>273</sup> Current speculation is that, despite election promises, Barak Obama will delay or even avoid overhauling the NAFTA so as to concentrate on the more immediate American economic crisis. However, it is arguable that foreign investment in the United States might have contributed to that crisis. See generally <<http://www.bloomberg.com/apps/news?pid=20601087&sid=avUEQDcf.ZxM&refer=home>>.

<sup>274</sup> On such considerations, see, for example, *Australia's Individual Action Plan under APEC*, <<http://www.apec-iap.org/>>.

<sup>275</sup> The nationalisation of the Mexican oil industry is the best-known example of Mexican expropriation. Other expropriations revolve around a series of devaluations of the Mexican peso, giving rise to litigation. See *Callejo v Bancomer*, 764 F 2d 101(5th Cir) 1985.

<sup>276</sup> On Australia's investment relationships with other countries in its region, see, for example, <<http://www.dfat.gov.au/apec/index.html>>.

<sup>277</sup> See, for example, H Mann and K Von Molte, *NAFTA's Chapter 11 and the Environment: Addressing the Impacts of the Investor-State Process on the Environment* (1999), <[http://www.iisd.ca/trade/chapter\\_11.htm](http://www.iisd.ca/trade/chapter_11.htm)>. But see John B Fowles, 'Swords into Ploughshares: Softening the Edge of NAFTA's Chapter 11 Regulatory Provisions' (2006) 36 *Cumb L Rev* 83.

## 16. AUSFTA

Australia's FTA with the United States is probably its most important. As such, it was heavily scrutinised, both in terms of its effect on trade and in regard to FDI in particular. In issue was not only the importance of the trade and investment relationship between Australia and the United States, but also the negotiating strategies, the objectives of the negotiators, and the outcomes sought and accomplished.<sup>278</sup>

Of paramount importance, the United States accounts for almost 30% of total FDI in Australia. As a result, it is the largest source of FDI for Australia, exceeding FDI from China or any other country. While this quantum of United States investment in Australia may change with the global recession, a potential shift to United States isolationism, and a shift by Australia towards regional investment partnerships, notably with China, the AUSFTA is likely to influence the governance of FDI well into the future. Added to this is the realisation that Australia has traditionally depended heavily on foreign capital for economic growth to offset the limitations of its resource-based economy. The result has been that investment inflows have traditionally exceeded investment outflows from Australia; something which Australia's FTAs and BITs are likely to perpetuate.<sup>279</sup>

Australia's goals in negotiating its FTA with the United States, beyond enhancing political solidarity with an important political and economic ally, was to enhance and regulate investment inflows and outflows, while reducing barriers to FDI between the two countries. Most formidable among these barriers were licensing requirements and regulations that the United States imposed on Australian direct investors.<sup>280</sup>

A preliminary issue for both countries, but perhaps more so for the United States, was concern over the pre-establishment screening of United States direct investments in Australia. The Australian Government, in turn, sought to maintain screening that would protect its national interest on public policy from Australian investments in the United States.<sup>281</sup>

The result was that both countries sought to liberalise FDI, but within seemingly carefully defined limits. The formal measure of the result was a series of amendments to United States and Australian trade and investment laws that restricted FDI to investors from the other party. Notable among its provisions, including their perceived benefits to Australian direct investors in the United States, were the following:

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<sup>278</sup> For an excellent discussion of the history of the AUSFTA, see Thomas Westcott, *Foreign Investment Issues in the Australia-United States Free Trade Agreement*,

<[http://www.treasury.gov.au/documents/958/pdf/06\\_foreign\\_investment\\_policy\\_ausfta.pdf](http://www.treasury.gov.au/documents/958/pdf/06_foreign_investment_policy_ausfta.pdf)>. See also Peter Drahos and David Henry, 'The Free Trade Agreement between Australia and the United States' (February 2007) *BMJ Com* 27; P Dee, 'The Australia-US Free Trade Agreement: An Assessment' (2005) 345 *Pacific Economic Papers*; Drusilla K Brown, Kozo Kiyota and Robert M Stern, 'Computational Analysis of the US FTAs with Central America, Australia and Morocco' (Oct 2005) 28(1) *The World Economy* 1441. See also <<http://www.ustr.gov/trade-agreements/free-trade-agreements/australian-fta>>.

<sup>279</sup> This is an ongoing concern as Australia concludes FTAs and BITs in its region as well as globally. See generally *Analysis of Key Obligations and Emerging Issues in International Investment Treaties*, <[http://www.firb.gov.au/content/international\\_investment/current\\_issues.asp?NavID=60](http://www.firb.gov.au/content/international_investment/current_issues.asp?NavID=60)>.

<sup>280</sup> For a discussion on the impact of these issues in the development of the AUSFTA, see *supra* n 278.

<sup>281</sup> *Ibid.*

- exemption from the *Foreign Acquisitions and Takeovers Act 1975* (Cth) of acquisitions of interests in financial sector companies as defined by the *Financial Sector (Shareholdings) Act 1998*;
- introduction of a screening threshold of A\$800 million, indexed annually to the GDP implicit price deflator, for acquisitions of interests in Australian businesses in non-sensitive sectors;
- introduction of a screening threshold of A\$50 million, indexed annually to the GDP implicit price deflator, for acquisitions of interests in Australian businesses in defined sensitive sectors. The sensitive sectors are:
  - media;
  - telecommunications;
  - transport, including airports, port facilities, rail infrastructure, international and domestic aviation and shipping services provided either within, or to and from, Australia;
  - the supply of training or human resources or the development, manufacture or supply of military goods, equipment or technology to the Australian or other defence forces;
  - the development, manufacture or supply of goods, equipment or technologies able to be used for a military purpose;
  - the development, manufacture or supply of, or provision of, services relating to encryption and security technologies and communications systems; and
  - the extraction of (or holding of rights to extract) uranium or plutonium, or the operation of nuclear facilities;
- introduction of a minimum screening threshold of \$50 million, indexed annually to the GDP implicit price deflator, for acquisitions by entities in which a United States federal or state government has a prescribed interest;
- introduction of a screening threshold of \$800m, indexed annually to the GDP implicit price deflator, for acquisitions of interests in non-residential developed commercial property (other than accommodation facilities); and
- removal of existing policy-based screening requirements for the establishment of new Australian businesses.<sup>282</sup>

Among the most significant changes arising from the AUSFTA was the distinction drawn between non-sensitive and sensitive sectors of the economy, and the protection accorded such sensitive sectors as the media and news coverage. The agreement also forewent the screening of

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<sup>282</sup> *Ibid.*

United States investments in financial sector companies and the requirement for notification of new (Greenfield) United States investments in Australia in excess of \$10 million.<sup>283</sup>

Chapter 11 of the AUSFTA provides in detail for FDI. It includes definitions and the scope of: foreign direct investment; non-discrimination obligations; investment protection; limitations on government measures; and dispute settlement procedures. The chapter is comparable in such coverage to Ch 11 of the NAFTA, discussed above. It is also similar to the Singapore-Australia FTA (SAFTA), except primarily in its treatment of investments in the services sector.<sup>284</sup>

The scope of the AUSFTA is circumscribed, in part, by an asset-based definition of 'investment'. Ch 11 in that agreement covers:

... every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk.<sup>285</sup>

Chapter 11 provides investors of each party with a guarantee against discrimination and prompt and adequate compensation for the expropriation of an investment. Non-discrimination principles are included in Art 11.3: national treatment; Art 11.4: most-favoured-nation treatment; and Art 11.5: minimum standard of treatment, with limited exceptions to these contained in annexes. The chapter also prescribes a minimum standard of treatment accorded to investors of the other party. It adopts the customary international minimum standard of treatment of aliens as its minimum standard of treatment. It also clarifies the meaning and scope of 'fair and equitable treatment' and 'full protection and security.' The chapter guarantees investors the right to freely transfer investments (including capital, profits and the like) in and out of the country. Article 11.9 on performance requirements imposes conditional incentives and related requirements on governments as a condition of their investment approval.

Particularly distinctive about the AUSFTA is the absence of investor-state dispute settlement provisions. While the United States was preoccupied with ensuring that the procedures used to resolve trade and investment disputes were expeditious and fair, Australia argued that the domestic courts of each country were the appropriate forum for addressing investor disputes. The Australian rationale was that both countries had comparable and advanced legal systems; both applied the rule of law; and that resort to investor-state arbitration was an unnecessary additional avenue. The Australian position ultimately prevailed.<sup>286</sup>

A further result of the lack of an investor-state mechanism for dispute settlement was that decisions by the Treasurer on foreign investment cases would not be subject to international arbitration in situations in which no similar rights were available to investors under domestic law.

In some measure, in declining to adopt a comparable dispute resolution mechanism to Ch 11 of the NAFTA, the parties to the AUSFTA avoided the potentially disparate nature and effect of NAFTA decisions outlined in the previous section. In relying on domestic courts to decide FDI disputes, the parties shifted the burden of developing a principled and transparent FDI regime to Australian and United States courts. It is too early to decide how domestic courts will execute this burden and how adeptly they will do so in this complex arena of FDI.

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<sup>283</sup> *Ibid.*

<sup>284</sup> *Ibid.*

<sup>285</sup> See Art 11.17.

<sup>286</sup> See generally *supra* n 278.

## 17. A Prism into Our Future

The purpose of most BITs and FTAs is to liberalise trade and investment. However, it is premature to confirm that such liberalisation has led foreign investors to divert their investments towards BIT and FTA partner countries and away from non-BIT and non-FTA partner countries.

One might assume that reductions in barriers to FDI, along with liberalisation of investment opportunities arising from BITs and FTAs would cause such shifts in the future, but that is not yet certain. In part, BITs and FTAs have evolved so swiftly that a liberalised investment regime between particular countries at one moment of time may be overtaken by a modified investment regime at the next. What is also not certain is the extent to which foreign investors might respond to changes in the legal regulation of FDI. This is particularly so in light of the limited number of test cases, before both domestic courts and international investment tribunals, relating to specific BITs and FTAs.

What *is* likely is that liberalised investment measures will lead to the diversion of investment from higher- to lower-cost FDI opportunities. In some measure, such shifts will depend on the conviction among foreign direct investors that cost savings negotiated by BIT and FTA parties are real rather than feigned, that they are measurable and sustainable over time and that differences arising over their application will be resolved in a principle and transparent manner against the background of investment liberalisation.

However, the future liberalisation of international investment will also depend significantly on how negative stereotypes about FDI are addressed. One such stereotype is that, regardless of the collective weight of the developing world, wealthy developed countries and their corporate investors will dominate global investment markets, while the regulation of FDI will be skewed in their favour.<sup>287</sup> The perceived result is that developing countries will have limited capacity to influence the terms and operation of FDI through BITs, FTAs and the WTO. Their further concern will be that, with the growth of FTAs and BITs, they may lose the strategic advantages of the WTO and revert to their historical status of economic and political disempowerment. These concerns may well arise in relation to Australia's developing neighbours, along with the perception of Australia as a developed country within the Asia region.<sup>288</sup>

Australia may find itself walking a tightrope in a potentially muted race towards the liberalisation of FDI offset by protectionism. On the one hand, Australia needs to secure advantageous standards of treatment for its investors abroad in order to bolster capital exports and to generate foreign revenues in a global climate of economic crisis. On the other hand, it

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<sup>287</sup> On the dominance by developed states over international trade and investment and challenges to that dominance by developing states, see, for example, James Oliver Gump, 'The West and the Third World: Trade, Colonialism, Dependence, and Development' (review) (Fall 2000) 11(2) *J World History* 396; D K Fieldhouse (ed), *The Theory of Capitalist Imperialism* (1967); Francis W Hirst (ed), *Free Trade and Other Fundamental Doctrines of the Manchester School* (1968); P J Cain and J A Hobson, 'Cobdenism, and the Radical Theory of Economic Imperialism, 1898–1914' (1978) 31(4) *Econ History Rev* 565; Michael Freeden, 'J A Hobson as a New Liberal Theorist: Some Aspects of his Social Thought Until 1914' (1973) 34(3) *J History of Ideas* 421.

<sup>288</sup> See Ivar Kolstad and Line Tøndel, *Social Development and Foreign Direct Investments in Developing Countries* (Michelson Institute, CMI Report 2002).

needs to insulate its vulnerable domestic interests from property rights asserted by foreign investors in order to promote domestic productivity.<sup>289</sup>

Given different economic, cultural and political interests in the regulation of FDI, developed and developing countries may fail to arrive at uniform standards by which to liberalise FDI.<sup>290</sup> Typifying their paralysis is the failure of the Organization for Economic Development and Cooperation to reach accord on a Multilateral Agreement on Investment in 1998,<sup>291</sup> the somewhat inconsequential results of the Doha Round; and the impasse on the liberalisation of FDI at Cancun.<sup>292</sup>

An offsetting benefit arising from the plethora of FTAs and BITs between developed and developing countries is the ability of some of them to reach bilateral agreements without invoking the collective might of the WTO, or lack thereof.<sup>293</sup> Nevertheless, a hazard associated with these FTAs and BITs is that, in serving as piecemeal mechanisms by which countries enter into discrete FTAs and BITs with different protocols, principles and standards, the uniform treatment of FDI may be lost. The worry is that the result will be a confusing patchwork quilt of FDI laws that are conflicting and disruptive of FDI initiatives. A related risk is that, however well intentioned, Australia and its FTA partners might add yet further distinctive features to that patchwork quilt.<sup>294</sup>

The further concern is that disparities in investment decisions may extend confusion over the boundaries of a 'legitimate' expropriation of FDI, doubt over a country's duty to pay 'adequate' compensation to impacted foreign investors, and dissent over its power to impose punitive measures. These problems are apparent in the jurisprudence surrounding Ch 11 of the NAFTA, and may well eventuate under different BITS and FTAs, including the AUSFTA.<sup>295</sup>

Another hazard of investment bilateralism is that domestic courts, exercising judicial review of the decisions of investment tribunals, may poison FDI. This concern is illustrated in

<sup>289</sup> On property rights in relation to international investment law, see generally Eric A Kades, 'Foreword: Property Rights and Economic Development' (2004) 45 *WM & Mary L Rev* 815; Thomas Wälde, 'Investment Arbitration as a Discipline for Good Governance in NAFTA Investment Law and Arbitration' in Todd Weiler (ed), *NAFTA, Investment Law and Arbitration* (2004).

<sup>290</sup> See, for example, Rene Lettow Lerner, 'International Pressure to Harmonize: The US Civil Justice System in an Era of Global Trade' (2001) 2001 *BYU L Rev* 229.

<sup>291</sup> See, for example, Robert Stumberg, 'Sovereignty by Subtraction: The Multilateral Agreement on Investment' (1998) 31 *Cornell Int'l LJ* 491.

<sup>292</sup> See Doha Ministerial Declaration, Fourth Ministerial Conference in Doha, Qatar, paras 20–22 (Nov 2001), <<http://www.wto.org>>. See also C Fred Bergsten, 'Avoiding Another Doha', *Washington Post*, 28 Feb 2006, reproduced by the Peterson Institute at <<http://www.iie.com/publications/opeds/oped.cfm?ResearchID=603>>; Robert M Stern, 'Perspectives on the WTO Doha Development' (2005) 5(4) *Global Economy J*.

<sup>293</sup> See, for example, Leon E Trakman, 'The Proliferation of Free Trade Agreements: Bane or Beauty?' *supra* n 69, <<http://www.law.bepress.com/unswwps/flrps/art54/>>. See also Vandavelde, *supra* n 70, at 169–70.

<sup>294</sup> See *supra* s 5v.

<sup>295</sup> In fairness, international negotiations have underscored both the need for greater harmonisation in the regulation of investment as well as ways in which to do so, including through regional and bilateral agreements. How instrumental such negotiations will be in the unification of international investment law and practice remains to be seen. See generally Kevin Kennedy, 'A WTO Agreement on Investment: A Solution in Search of a Problem?' (2003) 24 *U Pa J Int'l Econ L* 77. On the prospective impact of the Doha round of multilateral negotiations on Ch 11 of the NAFTA, see Bryan Swartz, 'The Doha Round and Investment: Lessons from Chapter 11 of NAFTA' in *NAFTA Investment Law and Arbitration* (2003); 3 *Asper Review of International Business and Trade* 12.

reactions to the *Loewen* case, which arose under Ch 11 of the NAFTA. There, a United States court allegedly imposed questionable punitive measures on foreign investors.<sup>296</sup> Comparable problems may arise insofar as BITS to which Australia is or may become a party provide for domestic courts to resolve FDI disputes.

Yet another difficult balancing act ahead is for the global community of countries to reach multilateral investment accord without jettisoning the value of BITS and FTAs. In issue is more than the functional need to redress the sovereign powers of countries over FDI, or to assess the procedural and substantive rights of foreign direct investors. What is required is a body of investment law in Australia, as elsewhere, that integrates investment rules and investment practice and that responds to the exercise of state powers. At the same time, that body of investment law ought to accord a reasonable measure of protection to foreign direct investors, while taking adequate account of the interests of host countries. In contention is the need for a workable agenda by which countries like Australia, its courts and investment tribunals charged with jurisdiction can together reform international investment protocols and standards without regressing into an impasse.<sup>297</sup>

An obstacle to achieving greater cohesion in international investment law is neither the institutional deficiencies arising from multiple bodies deciding investment cases, or even that those tribunals and domestic courts deciding investment cases may rely on a sometimes conflicting jurisprudence.<sup>298</sup> These differences are unavoidable in a complex world order in which investment practice operates at different levels of abstraction and where basic legal concepts relating to property rights differ perceptibly from one legal regime to another. A deeper dilemma lies in the elusiveness of a definitive international investment regime that is devised, sanctioned and recognised by the international community, as well as the countries that comprise it. If Ch 11 of the NAFTA serves as an example of a lack of uniformity in investment jurisprudence, that lack is likely to be further accentuated in an international regime that includes not only diverse BITS and FTAs, but also different mechanisms for resolving investment disputes. If the AUSFTA does anything, it accentuates institutional differences between reliance on domestic courts to resolve FDI disputes under that agreement and resort to investor-state investment tribunals. The result of that agreement may be that Australian and United States courts will carve out a relatively stable FDI jurisprudence. How that jurisprudence contributes to, or diverges from, existing international investment law remains uncertain at this early time.

## 18. Conclusion

A challenge ahead is to establish a politically sustainable pathway towards multilateral accord over the regulation of FDI. If the history of international investment law has demonstrated anything, it is that old habits die hard. Variations in the regulation of FDI disputes are likely to continue on a global checkerboard of BITS and FTAs. If countries like Australia are to continue to adopt disparate policies towards foreign investment in expressing their sovereign powers, than a homogenised, one-size-fits-all method of regulating FDI is assuredly ill-fitting. If the exercise

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<sup>296</sup> See *supra* n 278.

<sup>297</sup> For preliminary reflections on the need for 'sensible principles' to govern investor-state arbitrations in particular, see Jack Coe, 'The State of Investor-State Arbitration — Some Reflections on Professor Brower's Plea for Sensible Principles' (2005) 20 *Am U Int'l L Rev* 929. On resort to conciliation, see Jack Coe, 'Toward a Complementary Use of Conciliation in Investor-State Disputes — A Preliminary Sketch' (2005) 12 *UC Davis J Int'l L & Pol'y* 7.

<sup>298</sup> See, for example, Susan D Franck, 'The Legitimacy Crisis in Investment Arbitration: Privatizing Public International Law through Inconsistent Decisions' (2005) 73 *Fordham L Rev* 1521.

of state sovereignty is to be dynamic in its application, it is in Australia's interests to be part of that dynamic process in order to attract preferred FDI, not alienate it.

Finding common ground in the international investment arena is all about trade-offs made by countries like Australia between the perceived virtue of liberalised FDI and their legal responsibilities towards foreign investors. If the AUSFTA signifies anything, it is that treaty negotiators may agree to jettison the value of such 'basic' institutions as state-investor arbitration. Such a decision is not bad in itself; reliance on domestic courts may well be preferable to resolve FDI disputes under the AUSFTA rather than investment tribunals. Variations in the mechanisms used to regulate FDI are unavoidable if countries like Australia are to be free to devise FDI regimes in their national interest and through the exercise of their sovereign powers. The problem is that countries that accept their sovereign authority to regulate FDI may differ over how, when and to what degree to apply that authority to particular cases. The further problem is that domestic courts and also investment tribunals may accentuate those differences, rather than resolve them.

Divergences in the nature of international investment law itself is unavoidable in the face of a plethora of BITs and FTAs devised against the background of divergent political, cultural, economic and legal interests. For example, investment law in the EU rests upon distinctive principles, rules and procedures governing FDI, administered by centralised EU courts that respond significantly to EU constitutional dictates. Such uniformity is evident in the growth of such EU doctrines as 'direct applicability' and 'direct effect',<sup>299</sup> and the right of EU investors to gain access to national courts of EU member countries.<sup>300</sup> It would not be realistic to expect investment tribunals and courts in Australia, as elsewhere, to replicate EU jurisprudence in the face of the constitutional and legal variance from the EU. However, it would be realistic to expect Australian courts to consider customary international law along with the interpretation accorded to comparable BITs and FTAs in specific cases, including in light of constitutional and legal differences.

The question over how much one can expect investment tribunals to help devise a viable regime of FDI in the future is difficult to answer. International investment tribunals have already done much to enhance the burgeoning body of international jurisprudence. They have also helped to construct a body of international investment law that mediates between the complex interests of countries and the rights of foreign investors. However, it is unreasonable to expect them to carve out a coherent and sustainable regime for regulating FDI in the absence of a supportable institutional fabric. That fabric ultimately rests in the hands of countries that sometimes need to be reassured that the tailored liberalisation of FDI may benefit not only foreign investors, but the countries themselves. Complicating that fabric is not only that most BITs and FTAs adopt investor-state arbitration, while a few like the AUSFTA resort to domestic courts. The greatest complication arises over the uncertain legal scope of a basic concept like a legal 'expropriation.' So long as an expropriation is conceived of differently from one BIT and one tribunal to another, international investment jurisprudence will remain tenuous in nature and scope of application.

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<sup>299</sup> It is arguable that the NAFTA negotiators, rather than cede sovereignty, adopted international investment law to resolve disputes. It is more accurate to state that, in adopting Ch 11 of the NAFTA, each NAFTA party conceded the application of its domestic law and resort to its domestic courts in favour of an arbitral process grounded significantly in principles of international investment law.

<sup>300</sup> The problem under the EU regime is that access to the EU is not 'as of right', but is subject to particular treaty provisions that may vary from treaty to treaty.

# CANADA AND FOREIGN DIRECT INVESTMENT IN LATIN AMERICA AND THE CARIBBEAN: EVOLUTION OF AN INTERNATIONAL INVESTMENT AGREEMENT FRAMEWORK

Linda C Reif\*

## Abstract

Canadian foreign direct investment (FDI) in Latin America and the Caribbean has increased in recent decades, although there is a long history of Canadian FDI in the region. To protect its FDI, Canada has entered into bilateral or trilateral international investment agreements (IIAs) with some countries in the region. These IIAs are of three generations: (1) early bilateral foreign investment protection and promotion agreements (FIPAs); (2) NAFTA's investment chapter (Ch 11), FIPAs and free trade agreements (FTAs) based on NAFTA Ch 11; and (3) FIPAs and FTA investment chapters based on NAFTA Ch 11 experience. This paper examines the extent of coverage of Canadian IIAs in Latin America and the Caribbean and surveys the changing contents of the IIAs. While there are some differences between them, their written terms provide good protection for investors. However, their application in practice is uncertain due to their evolving contents that increasingly attempt to balance legitimate host-state regulation and foreign investor protection, the nature of the international arbitral process for investor-state disputes and the growth of anti-FDI movements in some Latin American states.

## 19. Introduction

Foreign direct investment (FDI) has exploded in importance in international business in recent decades.<sup>1</sup> Over the years Canada has seen increasing flows of outward FDI (OFDI), including into Latin America and the Caribbean. Although Canadian Governments have exhibited fluctuating interest in the region over the past decades, the current government has placed Latin America and the Caribbean high on their foreign policy agenda.<sup>2</sup> Canadian FDI in this region includes interests in diverse sectors such as financial services, mining, energy and manufacturing.

The moribund Free Trade Area of the Americas (FTAA) negotiations make hemispheric-wide legal regulation of FDI unlikely. Further, there are growing threats to North American FDI interests in some Latin American states that have elected populist leaders who are moving away from liberal FDI policies and towards greater national control of sensitive resource and business sectors. Thus, for the foreseeable future, the international law

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\* CN Professor of International Trade, Faculty of Law, University of Alberta. The research for this paper was funded by the University of Alberta Western Centre for Economic Research. The author is very grateful for the valuable research assistance provided by Lindy Shearer.

<sup>1</sup> FDI can be defined simply as investment of assets in a foreign country where there is a longer-term business commitment to the project through some level of control or influence over the investment project. FDI can be distinguished from portfolio investment which is relatively short-term investment in capital markets without entrepreneurial commitment. See M Sornarajah, *The International Law on Foreign Investment* (2nd ed, 2004) 7–9.

<sup>2</sup> Carlo Dade, 'Canada, the Americas and the Caribbean' (July–August 2007) 6:6 *FOCALPoint: Spotlight on the Americas* 1.

framework for Canadian FDI protection in the Americas will remain an amalgam of bilateral investment treaties (BITs) and equivalent chapters in free trade agreements (FTAs). These are backed up by the possibilities of binding international arbitration of foreign investor-host state-investor disputes. Contractual provisions and third-party political-risk insurance may also provide some support.<sup>3</sup>

Given the current politico-legal environment in the hemisphere, it is timely to examine the international law protections for Canadian FDI interests in Latin America and the Caribbean. In particular, this article will explore the growing number of Canadian international investment agreements (IIAs) — both bilateral investment treaties and FTA investment chapters — with countries in Latin America and the Caribbean. Canada has entered into a growing number of IIAs in the region, including a new focus on FTA investment chapters. While the overall number of IIAs currently covers only about one-third of independent states in the region, Canada has entered into IIAs with most of the nations in which there are substantial Canadian OFDI flows and is engaged in FTA investment chapter negotiations with many of the other independent states in the region.

The legal protections offered by these Canadian IIAs follow increasingly complex models. This article will explore the evolution of Canadian IIAs with Latin American and Caribbean countries. It will also highlight differences between these IIAs. It will then discuss various factors that are currently affecting the implementation of these IIAs. This paper argues that, regardless of their vintage, Canadian IIAs with Latin American and Caribbean states contain good substantive and procedural protections for investors. However, in practice, these legal protections remain uneven and uncertain. This is partly because the investment treaty international arbitration process is inherently uncertain in outcome. It is also because the contents of IIAs differ and increasingly reflect an attempt to balance foreign investor protection and legitimate host-state regulation. Finally, there are some pronounced anti-FDI movements in a few Latin American states that may negatively affect Canadian IIAs and investment.

## **20. Canadian Investment in Latin America and the Caribbean**

### **xxxv. Historical Background**

Canada has had a long history of doing business in the Americas beyond the United States. The Canadian banks and utility entrepreneurs were the major actors in this early period, starting in the late nineteenth century.<sup>4</sup>

Canadian banks based in Halifax began their international expansion into the United States and beyond, opening branches in the Caribbean in the late nineteenth century and becoming the dominant foreign banks in the Caribbean after World War I.<sup>5</sup> The expansion was based on Atlantic Canada's historical trading ties with the Caribbean and the commodity financing

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<sup>3</sup> This paper will not address the complexities of relevant contract law and political risk insurance.

<sup>4</sup> FDI in Latin America dates back to the mid-nineteenth century: Robert Grosse, 'International Business in Latin America' in Alan M Rugman and Thomas L Brewer (eds), *The Oxford Handbook of International Business* (2001) 652 at 655; Alan M Taylor, 'Foreign Capital Flows' in Victor Bulmer-Thomas, John H Coatsworth and Roberto Cortés Conde (eds), *The Cambridge Economic History of Latin America* (2006) vol 2 at 57.

<sup>5</sup> Neil C Quigley, 'The Bank of Nova Scotia in the Caribbean, 1889–1940' (1989) 63:4 *Business History Rev* 797, 799–807; Michael Bliss, *Northern Enterprise: Five Centuries of Canadian Business* (1987) 263–4.

expertise of the banks.<sup>6</sup> The Bank of Nova Scotia opened the first Canadian bank branch in the Caribbean in Kingston, Jamaica in 1889, followed by branches throughout Jamaica and in Cuba, Trinidad, Puerto Rico and the Dominican Republic in the early twentieth century.<sup>7</sup> The Merchants' Bank of Halifax (becoming the Royal Bank of Canada in 1901) started businesses in Bermuda in 1882, in Havana, Cuba in 1899 and later in numerous other Caribbean venues.<sup>8</sup> Canadian banks moved into Latin American countries in the early twentieth century. The Bank of Montreal and Canadian Bank of Commerce opened branches in Mexico City in 1906 and 1910 respectively.<sup>9</sup> In 1925, the Royal Bank of Canada increased its investments in Peru, Colombia, Venezuela and Costa Rica.<sup>10</sup> Canadian insurance companies also became active in some Latin American and Caribbean states in the late nineteenth and early twentieth centuries.<sup>11</sup>

Canada's infrastructure entrepreneurs of the same era moved on to international projects after the Canadian Pacific Railway was completed in 1885. Their exploits have been described by historian Michael Bliss:

Canadian companies built the electric street railways and installed power plants in far-away places like Sao Paulo and Rio de Janeiro, Brazil. Van Horne built a second transnational railway, from one end of Cuba to the other, and became the father of Guatemala's main line. A Canadian syndicate owned the Mexican Light and Power Company, the Mexico City street railway, utilities in Pachuca, Puebla, and Monterey, and the Mexican North Western Railway in Chihuahua. There were important Canadian utility interests in the United States, Barcelona, Spain, and half a dozen West Indian Islands. Canadian developers seemed to be everywhere, bringing light, power, and movement to usher communities into the modern century.<sup>12</sup>

Types of investment varied and, typically, Ontario corporations controlled the projects. Canadian investment in Mexico dates back to 1902 when a Canadian syndicate purchased the Necaxa waterpower concession and incorporated the Mexican Light and Power Company.<sup>13</sup> Five Canadian utilities were operating in Mexico, although incorporation occurred in Canada

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<sup>6</sup> Quigley, *ibid* at 837.

<sup>7</sup> *Ibid* at 808–28; Bliss, *supra* n 5 at 263–4.

<sup>8</sup> J C M Ogelsby, *Gringos From the Far North: Essays in the History of Canadian-Latin American Relations, 1866–1968* (1976) 106–10; Bliss, *ibid* at 264; Quigley, *ibid* at 814. The Canadian banks' Cuban operations were not nationalised by Castro but the resulting dearth of free market business led the banks to negotiate with the government on compensation for terminating their businesses: Paul E Sigmund, *Multinationals in Latin America: The Politics of Nationalization* (1980) 110.

<sup>9</sup> Ogelsby, *ibid* at 87, 93, 97, 99, 101, 158; Royal Bank on-line:

<<http://www.rbc.com/history/quicktofrontier/caribbean.html>>. The Royal Bank's operations in Costa Rica were caught up in the 1914–19 Tinoco affair. Tinoco's revolutionary government opened an account with the bank for government purposes. Tinoco and his brother drew large cheques on the account and left the country. The new Costa Rican Government refused to repay the bank and other foreign claimants. In international arbitration between Costa Rica and Great Britain, the latter exercising diplomatic protection of Canada and its claimant, the arbitrator rejected the claim: *Tinoco Arbitration, Great Britain v Costa Rica* (1923) 1 RIAA 369, rep. in (1924) 18 *Am J Int'l L* 147.

<sup>10</sup> Ogelsby, *ibid* at 93, 97, 99, 101.

<sup>11</sup> *Ibid* at 88, 92–3, 96, 97, 99, 101, 114.

<sup>12</sup> Bliss, *supra* n 5 at 329–30. The Barcelona Traction, Light and Power Company, also an Ontario corporation, was launched in 1912 and eventually failed, going down in international law history in *Barcelona Traction, Light and Power Co Case (Second Phase), Belgium v Spain* [1970] ICJ Rep 3.

<sup>13</sup> Christopher Armstrong and H V Nelles, 'A Curious Capital Flow: Canadian Investment in Mexico, 1902–1910' (1984) 58:2 *Business History Rev* 178, 185–6; Ogelsby, *supra* n 8 at 157–8.

as a ‘Canadian charter also offered the continuing advantages of a corporation law that was relatively lax and undemanding to the promoters by international standards’.<sup>14</sup>

Canadian involvement in Brazilian public utilities also began at the end of the nineteenth century. The Canadian corporations controlling the Brazilian investments were amalgamated in 1912 into one holding company, Brazilian Traction, Light and Power Company Limited, with electric streetcars and utility assets in Brazil.<sup>15</sup> The company — known locally as ‘The Light’ or the ‘Canadian octopus’ — was operated successfully until the 1960s when populist and then military governments embraced policies of economic nationalism, culminating in the nationalisation of the Brazilian entity in 1966.<sup>16</sup> Although much of the compensation had to be reinvested in Brazil, some capital was returned to Canada, resulting in Brascan, now Brookfield Asset Management Inc.<sup>17</sup> Other companies investing in Latin America in the first-half of the twentieth century included Massey-Harris in Argentina and Brazil, Hiram Walker in Argentina, Alcan in Uruguay and Brazil, and IPC (a Canadian subsidiary of Standard Oil) in Peru.<sup>18</sup>

Over the course of the twentieth century, Canadian investment in Latin America and the Caribbean was subject to changes in host government attitudes toward FDI, with a number of businesses experiencing expropriations, or deciding on negotiated buyouts of their property or voluntary termination of concessions.<sup>19</sup> Some Canadian investment in the region was purchased by other foreign investors. Until the last decade of the twentieth century, overall Canadian FDI in Latin America and the Caribbean was relatively modest.<sup>20</sup>

#### xxxvi. Evolution of Canadian OFDI in the Americas

Beginning during the World War I years, Canada slowly turned away from a very deep trade and investment relationship with the United Kingdom. Since that time Canada-United States two-way trade and investment flows have steadily increased.<sup>21</sup> This important bilateral FDI relationship was recognised in the investment chapter of the 1989 Canada-United States Free

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<sup>14</sup> Armstrong and Nelles, *ibid* at 187, 195–9, 202–3. Control over the companies quickly moved to Great Britain although the companies maintained their Canadian legal identities.

<sup>15</sup> Bliss, *supra* n 5 at 332–3; Ogelsby, *supra* n 8 at 129–39; Patricia Best and Ann Shortell, *The Brass Ring: Power, Influence and the Brascan Empire* (1988) 31–6: ‘... its owners, a group of Canadian and European investors ... allowed managers from the upright Canadian Bay Street law firm — Blake, Lash and Cassels — to run the company’s affairs for many decades’ (at 31).

<sup>16</sup> Best and Shortell, *ibid* at 36.

<sup>17</sup> *Ibid* at 499.

<sup>18</sup> Ogelsby, *supra* n 8 at 87, 91–5, 99, 142, 144; Sigmund, *supra* n 8 at 184–5. Extremely low taxes paid by IPC pursuant to a deal with an earlier government led the 1914 Peruvian Government to impose a massive tax increase on the company. Pressure was exerted on Peru by the Canadian Government and Standard Oil, resulting in an agreement to arbitrate followed by a 1922 settlement.

<sup>19</sup> For example, in Mexico, Brazil, Peru and Cuba: Ogelsby, *supra* n 8 at 93, 110, 140, 166, 169. See generally Patrick Del Duca, ‘The Rule of Law: Mexico’s Approach to Expropriation Disputes in the Face of Investment Globalization’ (2003) 51 *UCLA Law Rev* 35, 39, 41–5, 65–84.

<sup>20</sup> See Ogelsby, *supra* n 8 at 115–16, 291–3.

<sup>21</sup> J L Granatstein, ‘Free Trade between Canada and the United States: The Issue That Will Not Go Away’ in Denis Stairs and Gilbert R Winham (co-ords), *The Politics of Canada’s Economic Relationship With the United States*, vol 29, Research Studies for the Royal Commission on the Economic Union and Development Prospects for Canada (1985) 11, 28.

Trade Agreement (CUSFTA) and, even more clearly, in Ch 11 of the North American Free Trade Agreement (NAFTA).<sup>22</sup>

The stocks of Canadian OFDI have increased dramatically since the 1980s and Canada has been a net FDI exporter since 1997.<sup>23</sup> While the United States is the major destination state for Canadian OFDI, reliance on the United States as a destination for Canadian OFDI has dropped overall in the past 20 years.<sup>24</sup> In contrast, Canadian OFDI going to Latin America and the Caribbean has increased substantially in the past two decades both in absolute amounts and in the percentage of total outflows.<sup>25</sup> In 2006, Canada was the third-largest source country for FDI flows into Latin America and the Caribbean, although its ranking dropped in 2007.<sup>26</sup> Based on company-level information, it is estimated that ‘the value of investments by Canadian companies in Latin America and the Caribbean more than doubled over 2003–2007, from US\$18.3 billion to US\$37.4 billion, which ratifies the view that the Canadian business presence in the region is in a marked process of renewal and expansion’.<sup>27</sup>

In 2007, Canadian FDI stocks in Latin America and the Caribbean reached a total of \$117.28 billion compared to \$22.1 billion in 1995.<sup>28</sup> Outside of the United States, a few Caribbean offshore financial centres (OFCs) are the largest destinations for Canadian FDI in the Americas, influenced by their tax-friendly environments. In 2007, Barbados was the third-highest destination state for Canadian OFDI (\$36.24 billion), with the Cayman Islands standing in fifth place (\$17.55 billion), Bermuda in sixth place (\$17.44 billion), and the Bahamas ranking ninth (\$13.73 billion).<sup>29</sup> These four jurisdictions represented 72.5% of the stock of Canadian OFDI in Latin America and the Caribbean in 2007.<sup>30</sup> However, while some Canadian OFDI in these jurisdictions does not go to OFCs, the large amounts invested in Caribbean OFCs distorts the total OFDI picture, ‘because these flows of Canadian capital do not remain in OFCs, but go on to final destinations in third markets, mainly in Latin America

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<sup>22</sup> Canada-United States Free Trade Agreement (1988) 27 ILM 293 (in force 1989–93) (CUSFTA); North American Free Trade Agreement (1993) 32 ILM 296, 605, Ch 11 (in force 1 January 1994) (NAFTA).

<sup>23</sup> In 2007, \$514.5 billion of Canadian FDI abroad compared to \$500.8 billion of foreign FDI in Canada: Statistics Canada, ‘Foreign Direct Investment’, *The Daily*, 6 May 2008; Foreign Affairs and International Trade Canada, *Canada’s State of Trade: Trade and Investment Update 2007* (2007) 41–2. All dollar amounts are in Canadian dollars unless otherwise noted.

<sup>24</sup> ‘Foreign Direct Investment’, *The Daily*, *ibid*; *Canada’s State of Trade: Trade and Investment Update 2007*, *ibid* at 43. The share of Canadian investment in the United States stood at about 44% of total Canadian FDI in 2007, with a total stock of \$226.1 billion, a rate maintained over five years, but down from 51% one decade ago.

<sup>25</sup> UN Economic Commission for Latin America and the Caribbean, *Canada’s Trade and Investment With Latin America and the Caribbean*, UN Doc LC/WAS/L61 (29 January 2003) 7 (‘[I]n the past decade, Canada’s FDI in South and Central America grew almost 6-fold (583%)’); UN Economic Commission for Latin America and the Caribbean, *Foreign Investment in Latin America and the Caribbean 2007* (ECLAC, Preliminary Version, 2008) Ch 4.

<sup>26</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *ibid* at 5; UN Economic Commission for Latin America and the Caribbean, *Foreign Investment in Latin America and the Caribbean 2006* (ECLAC, Preliminary Version, April 2007) 30, 52. The top investors in the Caribbean in 2006 were Canada, the United Kingdom and the United States.

<sup>27</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *ibid* at 212.

<sup>28</sup> *Ibid* at 211 (based on Statistics Canada data).

<sup>29</sup> Barbados (30.9%), Cayman Islands (15%), Bermuda (14.9%), The Bahamas (11.7%), *ibid* at 210–11 (Statistics Canada data); ‘Foreign Direct Investment’, *The Daily*, *supra* n 23.

<sup>30</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *ibid* at 211. In 2007, Canadian FDI in these four jurisdictions amounted to 16.5% of total Canadian FDI abroad, compared to only 5.4% in 1997: ‘Foreign Direct Investment’, *The Daily*, *supra* n 23.

and the Caribbean, Asia, or the United States and Europe. Unfortunately, there is little information on where the capital moving through OFCs is ultimately invested'.<sup>31</sup>

Beyond OFC investment, Brazil has the largest amount of Canadian FDI in the region, with \$8.8 billion of Canadian OFDI in 2007.<sup>32</sup> Other Latin American and Caribbean states with healthy levels of Canadian OFDI in 2007 are Chile (\$6.99 billion); Mexico (\$4.95 billion); Argentina (\$2.5 billion); Peru (\$1.77 billion); Trinidad and Tobago (\$1.16 billion); and the Dominican Republic (\$1.15 billion).<sup>33</sup> Canadian OFDI in Venezuela (\$783 million) and Colombia (\$739 million) stood in a lower tier in 2007.<sup>34</sup> Below that, Canadian OFDI also went to the British Virgin Islands, another OFC (\$765 million); Guatemala (\$244 million); Bolivia (\$105 million); Costa Rica (\$88 million); Honduras (\$78 million); and Ecuador (\$53 million).<sup>35</sup> Canadian OFDI in or transhipped through the 15 Caribbean Community (CARICOM) members in 2006 stood at an eye-catching \$52.95 billion, although, as noted above, the OFCs of Barbados and the Bahamas would have been the predominant recipients of the OFDI.<sup>36</sup> In other parts of the Caribbean, Canadian FDI in Cuba was thought to be over \$1 billion by 2004.<sup>37</sup>

From another perspective, in 2007 Canadians were the main foreign investors in Chile and ranked among the top five largest investors by nationality in the Dominican Republic, Honduras, Mexico and Trinidad and Tobago.<sup>38</sup> Over the period 1997–2006, Canadians were the top foreign investors in Ecuador (29% of total inflows), the second-largest foreign investors in Honduras (3%), the third largest in Chile (16%) and the Dominican Republic (14%), and the fifth largest in El Salvador (7%), Costa Rica (3%) and Mexico (3%).<sup>39</sup>

Canadian FDI in Latin America and the Caribbean has markedly increased in the past twenty years, a period that coincides with the economic liberalisation of states in the region and the greater internationalisation of Canadian company operations. However, apart from a widely dispersed financial services sector, most Canadian OFDI is made in Mexico, Brazil, Chile, Argentina, Peru and Trinidad and Tobago.<sup>40</sup>

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<sup>31</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *ibid* at 192.

<sup>32</sup> Representing 7.5% of Canadian OFDI stocks in the region in 2007, *ibid* at 211 (Statistics Canada data); Foreign Direct Investment', *The Daily*, *supra* n 23. Brazil is a net FDI exporter to Canada, with \$12.8 billion invested by the end of 2007, *ibid*

<sup>33</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *ibid* at 211 (Statistics Canada data). For the purposes of this paper, Belize, Cuba, the Dominican Republic, Guyana and Suriname will be classified as Caribbean nations.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> Foreign Affairs and International Trade Canada, *Canada-Caribbean Community (CARICOM) Negotiations*: <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/caricom.aspx>> at 20 February 2008. CARICOM members are Antigua and Barbuda; the Bahamas; Barbados; Belize; Dominica; Grenada; Guyana; Haiti; Jamaica; Montserrat; St Kitts and Nevis; Saint Lucia; St Vincent and the Grenadines; Suriname; Trinidad and Tobago.

<sup>37</sup> Foreign Affairs and International Trade Canada, *Opening Doors to the World: Canada's International Market Access Priorities — 2006* (2006) 18 (at this date Canada was Cuba's largest foreign investor).

<sup>38</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 91–2.

<sup>39</sup> *Foreign Investment in Latin America and the Caribbean 2006*, *supra* n 26 at 77–8.

<sup>40</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 215. By 2007, mining company OFDI was found primarily in Mexico, Chile, Brazil, Argentina and Peru; oil and gas OFDI was concentrated in

Some Canadian banks continue to be heavily invested in Caribbean and Latin American states, and much Canadian OFDI in the Caribbean is in the financial services sector.<sup>41</sup> Scotiabank maintains extensive operations throughout the Caribbean and increasingly in Latin America.<sup>42</sup> Royal Bank of Canada has also maintained a strong Caribbean presence and, in recent years, has substantially increased its investment in the region.<sup>43</sup> Other Canadian financial institutions also have investments in the Caribbean and Latin America.<sup>44</sup>

In the Caribbean there is also Canadian FDI in the energy and natural resources sectors in Cuba and Trinidad and Tobago, and growing investment in the Dominican Republic in banking, tourism, infrastructure and textiles.<sup>45</sup> Sherritt International Corporation has diversified investments in Cuba in nickel and cobalt mining, oil and gas production, electricity production, hotels and agriculture.<sup>46</sup>

Canadian corporations have considerable OFDI in Latin America, particularly in the mining and oil and gas sectors. Canadian mining companies have investments in countries throughout Latin America.<sup>47</sup> Canada's FDI in Brazil has more than tripled since 1995, with exposure in the energy, mining, agri-business and telecommunications sectors.<sup>48</sup> Brookfield Asset Management Inc maintains large property and power investments in Brazil and Chile.<sup>49</sup> Canadian investment in Chile is primarily in the mining sector, and in sectors such as energy and manufacturing.<sup>50</sup> Canadian OFDI in the Andean countries focuses on mining, oil and gas, and telecommunications.<sup>51</sup> In particular, Canadian FDI in Peru has increased exponentially since the early 1990s, with much of it in the mining, banking, printing and hydroelectric sectors.<sup>52</sup> While Canadian FDI in Colombia is relatively lower, it is found in oil, mining and a

Colombia and Trinidad and Tobago; and manufacturing OFDI in the larger markets of Mexico, Brazil and Argentina, *ibid*

<sup>41</sup> *Ibid* at 213; *Canada's Trade and Investment with Latin America and the Caribbean*, *supra* n 25 at 7.

<sup>42</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 (estimated \$3.37 billion investment in Latin America and the Caribbean as of 2007). See on-line: <<http://www.scotiabank.com>>.

<sup>43</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 (estimated \$2.19 billion investment in Latin America and the Caribbean as of 2007); Tavia Grant, 'RBC calls Caribbean Purchase A Platform For Growth', *The Globe and Mail*, 3 October 2007, at B7: <<http://www.rbc.com>> (RBC also has offices in Argentina and Uruguay).

<sup>44</sup> For example, CIBC, Onex Corp and Sun Life Financial: *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25.

<sup>45</sup> *Canada's Trade and Investment With Latin America and the Caribbean*, *supra* n 25 at 7.

<sup>46</sup> Sherritt International Corporation: <<http://www.sherritt.com>>; Archibald R M Ritter, 'The Cuban Economy After Fidel' (February 2007) *FOCALPoint Special Issue 5* (Sherritt has US\$450 million investment in nickel sector).

<sup>47</sup> The OFDI of Canadian mining companies is quite large in relation to the size of the sector while the opposite is true for the Canadian oil and gas industry: *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 208–9, 213–14. For example, Goldcorp Inc: <[www.goldcorp.com](http://www.goldcorp.com)>; Yamana Gold Inc: <[www.yamana.com](http://www.yamana.com)>; Barrick Gold Corporation: <[www.barrick.com](http://www.barrick.com)>; Teck Cominco Limited: <[www.teckcominco.com](http://www.teckcominco.com)>; Rusoro Mining: <[www.rusoro.com](http://www.rusoro.com)>; Kinross Gold Corporation: <[www.kinross.com](http://www.kinross.com)>.

<sup>48</sup> *Canada's Trade and Investment With Latin America and the Caribbean*, *supra* n 25 at 8.

<sup>49</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 213 (estimated \$5.57 billion investment as of 2007); <<http://www.brookfield.com>>.

<sup>50</sup> *Ibid* at 213–14; *Canada's Trade and Investment With Latin America and the Caribbean*, *supra* n 25 at 8; Timothy David Clark, 'Canadian Mining in Neo-Liberal Chile: Of Private Virtues and Public Vices' in Liisa North, Timothy D Clark, and Viviana Patroni (eds), *Community Rights and Corporate Responsibility: Canadian Mining and Oil Companies in Latin America* (2006) 90 (Community Rights and Corporate Responsibility).

<sup>51</sup> *Canada's Trade and Investment With Latin America and the Caribbean*, *supra* n 25 at 7–8.

<sup>52</sup> *Ibid*.

variety of other sectors.<sup>53</sup> However, Canadian OFDI in the oil and gas sector in the region has recently dropped markedly, in part due to more restrictive government controls.<sup>54</sup> Other Canadian OFDI in Latin America is found in diverse industries. For example, in Mexico, there is considerable investment in the manufacturing sector as well as in mining, banking, energy and agri-food.<sup>55</sup>

## 21. Fluctuating Attitudes of Latin American and Caribbean Nations to FDI

As the history of Canadian FDI in the western hemisphere illustrates, there have been pendulum swings in the attitudes towards FDI on the part of Latin American and Caribbean states over the years. In Latin America, the mid-nineteenth to early twentieth century period was marked by open, liberal policies concerning trade and foreign investment.<sup>56</sup> This was also the period when the early Canadian FDI flows moved into Latin America. However, trade and investment policies in Latin America and the Caribbean in the post-World War II period changed to those designed to promote domestic economic development through import-substitution and the restriction of FDI.<sup>57</sup> Expropriations of foreign investment were undertaken in a number of states in the region, early on in Mexico and in other nations mainly after World War II until the 1970s.<sup>58</sup>

As a result of economic and political changes occurring mainly during the 1980s and 1990s — ranging from the Mexican debt crisis to a wave of democratisations—states in the region adopted neo-liberal economic policies and changed their policies and laws to support more open international trade and investment.<sup>59</sup> In addition, regional economic integration initiatives have deepened and expanded in the past two decades, including the Southern Common Market (MERCOSUR), CARICOM, the Andean Community, the Central American Common Market and many other plurilateral and bilateral FTAs.<sup>60</sup> Although there are other contributing factors, higher levels of FDI flowed into Latin America and the Caribbean starting in the 1990s.<sup>61</sup>

In the early twenty-first century, however, a few states in Latin America have become disillusioned with neo-liberal policies and governments have been elected with more hostile

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<sup>53</sup> *Ibid* at 8; Scott Pearce, 'Tackling Corporate Complicity: Canadian Oil Investment in Colombia' in *Community Rights and Corporate Responsibility: Canadian Mining and Oil Companies in Latin America* (2006) at 160.

<sup>54</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 217–20.

<sup>55</sup> *Canada's Trade and Investment With Latin America and the Caribbean*, *supra* n 25 at 7; Foreign Affairs and International Trade Canada, *Canada's International Market Access Report 2007* (2007) 16–17; *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 222.

<sup>56</sup> Victor Bulmer-Thomas, *The Economic History of Latin America Since Independence* (2nd ed, 2003) 14, 46–151; Luis Bértola and Jeffrey G Williamson, 'Globalization in Latin America Before 1940' in *The Cambridge Economic History of Latin America*, *supra* n 4, at 37–8.

<sup>57</sup> Bulmer-Thomas, *ibid* at 17, 232–352; Grosse, *supra* n 4 at 657.

<sup>58</sup> Stephen Zamora et al, *Mexican Law* (2004) 35; Andreas F Lowenfeld, *International Economic Law* (2002) 397; Stephen J Randall, 'The Historical Context' in Richard S Hillman and Thomas J D'Agostino (eds), *Understanding the Contemporary Caribbean* (2003) 51, 79.

<sup>59</sup> Bulmer-Thomas, *supra* n 56 at 17–18, 353–91; Grosse, *supra* n 4 at 657–62.

<sup>60</sup> See, for example, UN Economic Commission for Latin America and the Caribbean, *Latin America and the Caribbean in the World Economy, 2005–2006* (UN ECLAC, October 2006) Ch IV; McGill Preferential Trade Agreements Database: <<http://www.ptas.mcgill.ca>>.

<sup>61</sup> Grosse, *supra* n 4 at 668–71.

attitudes toward foreign investment in their economies. While countries such as Chile, Brazil, Peru, Uruguay, Colombia and Mexico continue to support economic liberalisation, other states — notably Venezuela, Bolivia and Ecuador — have adopted populist stances toward foreign investment that are increasingly nationalistic, especially in the natural resources and infrastructure sectors.<sup>62</sup>

Venezuela's Hugo Chavez has nationalised his country's electricity, steel, cement, mining and telecommunications sectors over the past few years and has exerted control over the energy sector, including the 2007 nationalisation of consortiums in the Orinoco River oil fields controlled by western oil companies and a 2008 tax on excess oil profits.<sup>63</sup> Most foreign investors consented to new joint venture agreements giving Venezuela's state-owned oil company, PDVSA, majority control. ExxonMobil and ConocoPhillips did not, and commenced international arbitration claims against Venezuela.<sup>64</sup> In Bolivia, the election of Evo Morales led to 2005 hydrocarbons legislation raising royalty rates and a May 2006 decree nationalising hydrocarbons.<sup>65</sup> After the nationalisation, foreign investors had to sign new operating contracts that transferred ownership to the state and the government raised tax rates further.<sup>66</sup> Ecuador amended its hydrocarbons legislation in 2007, giving the government 99% of windfall profits of foreign oil companies, and in 2008 began to renegotiate its contracts with foreign oil companies.<sup>67</sup> In April 2008, Ecuador's constitutional assembly passed a mining mandate pending the passage of a new mining law that *inter alia* revokes 80% of unexploited mining concessions that revert to the state without compensation.<sup>68</sup> Argentina has terminated infrastructure contracts with foreign investors.<sup>69</sup> All four countries are facing international arbitral claims lodged by aggrieved foreign investors.<sup>70</sup>

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<sup>62</sup> Jorge G Castañeda, 'Latin America's Left Turn' (May/June 2006) 85:3 *Foreign Affairs* 28. See also Cuba and Nicaragua: UNCTAD *World Investment Report 2008, Transnational Corporations and the Infrastructure Challenge* (UN, 2008) 12–13 (UNCTAD *World Investment Report 2008*).

<sup>63</sup> UNCTAD *World Investment Report 2007, Transnational Corporations, Extractive Industries and Development* (UN, 2007) 59 (UNCTAD *World Investment Report 2007*); UNCTAD *World Investment Report 2008*, *ibid* at 64, 155; *Foreign Investment in Latin America and the Caribbean 2006*, *supra* n 26 at 47; Luis A Pacheco, 'High Noon at the Orinoco River: Venezuela and Exxon–Mobil' (March 2008) 7:2 *FOCALPoint: Spotlight on the Americas* 14.

<sup>64</sup> See International Centre for the Settlement of Investment Disputes (ICSID), *List of Pending Cases*: <<http://www.icsid.worldbank.org>>; UNCTAD *World Investment Report 2008*, *ibid* at 13; 'Exxon's Wrathful Tiger Takes on Hugo Chávez', *The Economist*, 16 February 2008, p 43.

<sup>65</sup> UNCTAD *World Investment Report 2007*, *supra* n 63 at 15, 57, 59; *Foreign Investment in Latin America and the Caribbean 2006*, *supra* n 26 at 47; Bolivia, Supreme Decree No 28701 (1 May 2006) (2006) 45 *ILM* 1020.

<sup>66</sup> *Foreign Investment in Latin America and the Caribbean 2007*, *supra* n 25 at 219; UNCTAD *World Investment Report 2008*, *supra* n 62 at 13.

<sup>67</sup> Xavier Andrade Cadena and Marco Tulio Montañes, 'Introductory Note to Ecuador's Notice under ICSID Article 25(4)' (2008) 47 *ILM* 154; UNCTAD *World Investment Report 2008*, *ibid* at 64; *Foreign Investment in Latin America and the Caribbean 2006*, *supra* n 26 at 47.

<sup>68</sup> Ian Harris, 'Ecuador's Mineral Crossroads: Canada's Commitment' (June 2008) 7:5 *FOCALPoint: Spotlight on the Americas* 1.

<sup>69</sup> UNCTAD *World Investment Report 2008*, *supra* n 62 at 55, 64.

<sup>70</sup> See *infra* text accompanying nn 133–6.

## 22. The International Law Framework Protecting FDI in Latin America and the Caribbean

### xxxvii. i. Evolution of Bilateral Treaty Law and Failure of the FTAA Negotiations

There are a number of commercial, economic, political and legal risks or factors that investors take into account in deciding whether to invest in a foreign state. The investment contract and international law can be used to try to protect the FDI and may serve as the foundation for domestic or international dispute settlement mechanisms to try to recover damages for loss of the investment.

Historically, aggrieved foreign investors would have to initially rely on the domestic courts of the host state (usually an unsatisfactory situation) and then, if an acceptable resolution had not been achieved, hope that their national states would espouse a diplomatic claim on their behalf against the host government based on customary international law.<sup>71</sup> Early treaty law, in the form of the bilateral Friendship, Commerce and Navigation (FCN) Treaty was sub-optimal — while some investment protection was included, the FCN treaty did not focus on all aspects of international investment relationships and contained either no dispute resolution mechanism or only inter-state provisions.<sup>72</sup> More recently, treaty law, primarily bilateral investment treaties (BITs) and trade agreements containing investment chapters, have imposed a full range of obligations on host states with respect to treatment of the covered foreign investment and many have established the right for foreign investors to make international arbitration claims directly against host states.

However, large multilateral initiatives have been unsuccessful to date.<sup>73</sup> In the Americas, the idea for a FTAA to include 34 states was adopted at the 1994 Miami Summit of the Americas.<sup>74</sup> Formal negotiations began in 1998, with the objective of completing the FTAA negotiations by January 2005.<sup>75</sup> However, differences between the negotiating states became more pronounced and the negotiations eventually collapsed.<sup>76</sup> The draft text had included an investment chapter, albeit heavily square-bracketed, but the move to a plurilateral model ‘effectively eliminated the possibility that strong investment disciplines like those found in ... [NAFTA] and opposed by major players such as Brazil, would eventually be included in any FTAA-lite’.<sup>77</sup> Subsequently, some South American states began to focus on regional

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<sup>71</sup> See, for example, Kenneth J Vandeveld, ‘A Brief History of International Investment Agreements’ (2005–06) 12 *UC Davis J Int'l L & Pol'y* 157 at 158–66 (‘Brief History’); Carlos G Garcia, ‘All the Other Dirty Little Secrets: Investment Treaties, Latin America, and the Necessary Evil of Investor-State Arbitration’ (2004) 16 *Fla J Int'l L* 301, 323–7.

<sup>72</sup> Vandeveld, *ibid.*

<sup>73</sup> Gus Van Harten, *Investment Treaty Arbitration and Public Law* (2007) 18–23.

<sup>74</sup> I Summit of the Americas Declaration of Principles and Plan of Action (1995) 34 *ILM* 808. See generally, Antoni Estevadeordal et al (eds), *Integrating the Americas: FTAA and Beyond* (2004).

<sup>75</sup> Formal negotiations were launched at the Second Summit of the Americas held in Santiago, Chile: II Summit of the Americas Declaration of Santiago (1998) 37 *ILM* 950. The heads of state/government meeting at the 2001 Third Summit of the Americas in Quebec City, Canada, set 1 January 2005 as the deadline for completion of the negotiations and the end of 2005 as the deadline for the treaty’s entry into force: III Summit of the Americas Declaration of Quebec City (22 April 2001).

<sup>76</sup> Rubens Antonio Barbosa, ‘The Free Trade Area of the Americas and Brazil’ (2003–04) 27 *Fordham Int'l LJ* 1017, 1020–2.

<sup>77</sup> Paul A Haslam, ‘The Emerging Foreign Investment Regime in the Americas’, FOCAL Policy Paper, FPP-05-01 (January 2005) 2; FTAA, Third Draft Agreement, Doc FTAA TNC/w/133/Rev 3 (21 November 2003) Ch

integration and, on 23 May 2008, 12 South American states signed the treaty establishing the Union of South American Nations (UNASUR).<sup>78</sup>

Given the new political climate in parts of Latin America, FTAA negotiations are unlikely to be successful, at least in the short- or medium-term. Also, the collapse of negotiations for a multilateral agreement on investment (MAI) in the late 1990s and the deletion of investment from the World Trade Organization (WTO) Doha Round agenda indicate that a broader multilateral investment agreement is not feasible in the same time frame.<sup>79</sup> This legal evolution leaves FDI relations between countries in the Americas based predominantly on a web of bilateral and sub-regional trade and investment treaties. Accordingly, Canada's FDI relationships in Latin America and the Caribbean are, and will continue to be for the foreseeable future, supported mainly by bilateral and sub-regional IIA rights and obligations.

### xxxviii. BITs and FTA Investment Chapters

#### a. Overview

The BIT dates back to 1959, when developed, capital-exporting states in Europe began to use a focused bilateral treaty to protect their FDI in developing states.<sup>80</sup> With the change in attitude towards FDI during the 1980s, the number of BITs rapidly increased after this point. By the end of 2007, there were approximately 2,608 BITs in existence, involving a total of 179 states.<sup>81</sup> In the early years, most BITs were entered into between capital-exporting, developed states and capital-importing, developing states, with most of the investment flowing to, and the treaty obligations actually incumbent upon, the developing state. However, by the end of 2007, only about 53% of BITs were between developed states and developing or transition states. The remaining BITs were mainly between developing/transition states, with BITs between developed nations representing 9% of total BITs.<sup>82</sup> More recently, there has been a noticeable increase in trade agreements that contain investment chapters. By the end of 2007, in addition to the BITs, there were 254 trade agreements (often FTAs) containing investment chapters that are typically equivalent to BITs in the scope of their coverage and dispute settlement rules.<sup>83</sup>

The United Nations Conference on Trade and Development (UNCTAD) notes how these BITs and trade agreement investment chapters, collectively called 'international investment agreements' (IIAs), are becoming 'increasingly complex and diverse'.<sup>84</sup> The proliferation of trade agreements containing investment chapters can be partly attributed to the contemporary viewpoint that international trade and investment are complementary, even interconnected

XVII; Kevin C Kennedy, 'The FTAA Negotiations: A Melodrama in Five Acts' (2003–04) 1 *Loyola U Chi Int'l L Rev* 121, 131–4 (plurilateral model allowed states to take on different levels of obligation in different sectors).

<sup>78</sup> 'South American Leaders Form Unasur' (May 2008) 7:4 *FOCALPoint: Spotlight on the Americas* 9; UNCTAD *World Investment Report 2006, FDI from Developing and Transition Economies: Implications for Development* (2006) (UNCTAD *World Investment Report 2006*) 75.

<sup>79</sup> See Van Harten, *supra* n 73 at 21–3. The WTO Agreement has some limited investment rules in the Trade-related Investment Measures (TRIMs) Agreement, the GATS and the TRIPs Agreement; *Marrakesh Agreement Establishing the World Trade Organization*, April 15, 1994, 1867 *UNTS* 154, (1994) 33 *ILM* 1144 (in force 1 January 1995).

<sup>80</sup> 1959 West Germany-Pakistan BIT: Vandeveld, *supra* n 71 at 169.

<sup>81</sup> UNCTAD *World Investment Report 2008*, *supra* n 62 at xvii, 14.

<sup>82</sup> *Ibid* at 16.

<sup>83</sup> *Ibid* at xvii, 16.

<sup>84</sup> *Ibid* at 17.

and mutually-supportive activities, so that their international law protection should be combined in one treaty relationship.<sup>85</sup> NAFTA Ch 11 is a prime example of an FTA with an investment chapter equivalent to a BIT.

Vandeveldel has noted the growth in trade agreements with investment chapters and has stated:

[I]nvestment agreements increasingly are intended to liberalise investment flows. They have become instruments of globalisation, removing barriers to trade and investment, much in the same way that the FCNs of the Eighteenth and Nineteenth Centuries sought to establish commercial relations between countries.<sup>86</sup>

However, in contrast to their role in providing legal protection for investment already in the host state, there is a difference of opinion on whether BITs have the effect of actually increasing FDI flows to the countries covered by the treaties.<sup>87</sup> It has also been argued that the spread of BITs is in part due to competition between potential host state parties for FDI, resulting only in FDI diversion.<sup>88</sup> Then, there is always the case of Brazil which has never ratified a BIT and yet remains a popular destination for FDI in Latin America.<sup>89</sup> According to Susan D Franck, Brazil represents a ‘market liberalisation model’ state — a nation that attracts FDI despite an absence of BIT obligations because it has clearly modernised and liberalised its economy.<sup>90</sup>

#### **b. Contents of BITs and FTA Investment Chapters**

BITs and FTA investment chapters contain substantive obligations binding on the host-state government covering the foreign investment/investor, and mechanisms for the settlement of disputes arising out of the covered investments.<sup>91</sup> Early BITs were quite simple, but model

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<sup>85</sup> Vandeveldel, *supra* n 71 at 180–1.

<sup>86</sup> *Ibid* at 183.

<sup>87</sup> See, for example, Susan D Franck, ‘Foreign Direct Investment, Investment Treaty Arbitration and the Rule of Law’ (2007) 19 *Pacific McGeorge Global Bus & Dev’t L J* 337, 347–53 (‘Foreign Direct Investment’); Deborah L Swenson, ‘Why Do Developing Countries Sign BITs?’ (2005–06) 12 *UC Davis J Int’l L & Pol’y* 131 (BITs signed in the late 1990s correlated with increased FDI; BITs signed in early 1990s not so correlated); Zachary Elkins, Andrew T Guzman, and Beth A Simmons, ‘Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960–2000’ (2006) 60 *Int’l Organization* 811, 823 n 30; Jeswald W Salacuse and Nicholas P Sullivan, ‘Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain’ (2005) 46 *Harvard Int’l L J* 67 (United States BITs and, to a lesser degree, other OECD state BITs, have positive impact on investment promotion); Eric Neumayer and Laura Spess, ‘Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?’ (2005) *World Dev’t* 1567 (higher number of BITs increases FDI flows to a developing state).

<sup>88</sup> Elkins, Guzman, and Simmons, *ibid* at 812. See also Andrew Guzman, ‘Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties’ (1998) 38 *Va J Int’l L* 639.

<sup>89</sup> *Infra* text accompanying n 132 on Brazil and BITs.

<sup>90</sup> Franck, ‘Foreign Direct Investment’, *supra* n 87 at 361–4.

<sup>91</sup> See generally UNCTAD, *Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking* (2007) (*Bilateral Investment Treaties 1995–2006*); Van Harten, *supra* n 73; John W Boscariol, ‘Foreign Investment Protection Treaties: Opportunities in the Petroleum Industry’ (2006) 44 *Alberta L Rev* 115; Susan D Franck, ‘The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions’ (2004–05) 73 *Fordham L Rev* 1521 (‘The Legitimacy Crisis’); Kenneth J Vandeveldel, ‘The Political Economy of a Bilateral Investment Treaty’ (1998) 92 *Am J Int’l L J* 621; Kenneth J Vandeveldel, ‘Investment Liberalisation and Economic Development: The Role of Bilateral Investment Treaties’ (1998) 36

BITs have become increasingly complex over time, influenced by BIT practice, investor-state arbitration and the operation of NAFTA Ch 11.<sup>92</sup> Beyond investor-state disputes based on the relatively narrow terms of any relevant investment contract, BITs ‘expose the state to claims by a broad class of potential claimants in relation to any government activity affecting foreign investors, in the absence of a contract between an individual investor and the state’.<sup>93</sup>

Most BITs contain many of the same substantive provisions in general terms, but they vary considerably in the details. Often, BITs contain a broad definition of the ‘investment’ that is protected, going beyond FDI to include interests such as intellectual property rights and portfolio investment.<sup>94</sup> In order to be protected by the BIT and make a claim against the host state, the investor must be considered to be a national of the other BIT state — corporate investors may sometimes change their nationality to ‘forum shop’ for the most advantageous BIT when they want to bring a claim against a host state.<sup>95</sup> Most BITs do not contain a right of establishment of investment in the host state, although a few states are including a right of admission in their BITs; for example, the United States, Canada and Japan.<sup>96</sup> The latter grants national treatment and/or most-favoured-nation (MFN) rights in the investment establishment phase, albeit with exclusions and reservations.<sup>97</sup>

The ‘national treatment’ principle requires that the host state give foreign investors and investment from the other contracting state treatment that is no less favourable than the treatment given to the host state’s domestic investors.<sup>98</sup> Some BITs qualify this obligation, such as by limiting it to where the foreign and domestic investors are in like circumstances and/or by providing reservations or exclusions. The MFN principle requires that the host state must provide no less favourable treatment to investors/investment of the other contracting state vis-à-vis the treatment given to investors/investment from third countries.<sup>99</sup> Again, this obligation may be subject to reservations and exclusions. The minimum standard of treatment (or fair and equitable treatment) of the investment under customary international law obligation is an absolute standard.<sup>100</sup>

Protection against expropriation has always been an important feature of BITs and typically host states are permitted to expropriate or nationalise covered foreign investment if it is done on a non-discriminatory basis, for a public purpose, in accordance with due process of law and compensation is paid to the investor.<sup>101</sup> Differences remain, for example, on the delimitation of the boundaries between compensable direct/indirect expropriation and

*Columbia J Transnat'l L* 501; Kenneth J Vandeveld, ‘Sustainable Liberalism and the International Investment Regime’ (1998) 19 *Mich J Int'l L* 373.

<sup>92</sup> See for example, Meg Kinnear and Robin Hansen, ‘The Influence of NAFTA Chapter 11 in the BIT Landscape’ (2005–06) 12 *UC Davis J Int'l L & Pol'y* 101.

<sup>93</sup> Van Harten, *supra* n 73 at 25, 57.

<sup>94</sup> *Ibid* at 77–8; *Bilateral Investment Treaties 1995–2006*, *supra* n 91 at xi, 7–13.

<sup>95</sup> Boscariol, *supra* n 91 at 144.

<sup>96</sup> Van Harten, *supra* n 73 at 27–8, 84; *Bilateral Investment Treaties 1995–2006*, *supra* n 91 at xi, xiii, 21–6.

<sup>97</sup> *Bilateral Investment Treaties 1995–2006*, *ibid* at xi, 23–6.

<sup>98</sup> *Ibid* at 33–8.

<sup>99</sup> There have been conflicting arbitral awards on whether a BIT MFN clause extends beyond coverage of substantive measures to encompass dispute settlement provisions in other BITs entered into by the host state: see for example, *Maffezini v Kingdom of Spain*, ICSID No ARB/97/7 (Award of Tribunal 13 November 2000) and subsequent awards: *ibid* at 38–43. See also *Wintershall* award, *infra* n 175.

<sup>100</sup> *Ibid* at 28–33; Sornarajah, *supra* n 1 at 235–6, 328–39 (recent practice indicates that the fair and equitable treatment standard is not higher than, and is equivalent to, the international minimum standard of treatment).

<sup>101</sup> *Ibid* at 44–52.

legitimate government regulation.<sup>102</sup> Compensation for losses caused by international or civil armed conflict in the host state is also commonly found in BITs, although these provisions often provide only for compensation on a non-discriminatory basis in relation to the compensation given to domestic investors.<sup>103</sup> In addition, BITs usually contain a provision requiring the host state to ensure the prompt transfer of funds connected with the foreign investment.<sup>104</sup>

Many BITs do not prohibit a host state's use of performance requirements, such as provisions that require certain levels of domestic content in the product manufactured by the foreign investment or requiring the foreign investor to export a certain amount of the product.<sup>105</sup> However, some BITs and FTA investment chapters concluded from the 1990s (for example, those of the United States, Canada and Japan) do prohibit various performance requirements, typically in considerable detail.<sup>106</sup>

A number of BITs drafted in the early years contain 'umbrella clauses' pursuant to which 'the host country usually assumes the responsibility to respect other obligations it has with regard to investments of investors of the other contracting party'.<sup>107</sup> The majority of arbitral awards construing umbrella clauses drafted in broad terms have found they cover all state obligations, including investor-state contracts. However, several recent awards have reached conflicting decisions on their scope.<sup>108</sup>

Many BITs concluded since 1995 exclude or limit the coverage of certain sectors or government measures to protect core domestic public policies in areas such as taxation, financial services safety, national security and cultural diversity/cultural industries.<sup>109</sup> The latest model BITs for Canada and the United States 'aim to reach a better balance between the protection of investment and the protection of state sovereignty'.<sup>110</sup> Thus, Canada and the United States (placed in the host state position in NAFTA Ch 11 arbitral claims) now clarify the scope of some substantive obligations and grant relatively weak rights for the host state to take protective measures in areas such as environmental protection.<sup>111</sup>

The core BIT and FTA investment chapter dispute settlement provisions are those that permit a foreign investor to unilaterally launch international arbitration against the host state when the investor claims that the host state has violated one or more of the substantive provisions

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<sup>102</sup> *Ibid* at 44–7.

<sup>103</sup> *Ibid* at 52–6.

<sup>104</sup> *Ibid* at 56–63.

<sup>105</sup> *Ibid* at xii, 64–5.

<sup>106</sup> *Ibid* at 66–9.

<sup>107</sup> *Ibid* at 73 (about 40% of the approximately 2,500 BITs contained umbrella clauses).

<sup>108</sup> *Ibid* at 74–5.

<sup>109</sup> *Ibid* at xiii, 80–99. Protection of cultural matters and industries is found in Canadian and French BITs.

<sup>110</sup> Gilbert Gagné and Jean-Frédéric Morin, 'The Evolving American Policy on Investment Protection: Evidence From Recent FTAs and Their 2004 Model BIT' (2006) 9:2 *J Int'l Econ L* 357, 359; Agreement Between Canada and \_\_\_\_\_ for the Promotion and Protection of Investments (Canada 2004 Model FIPA): <<http://www.international.gc.ca/assets/trade-agreements-accords-commerciaux/pdfs/2004-FIPA-model-en.pdf>>; Treaty Between the Government of the United States of America and the Government of [Country] Concerning the Encouragement and Reciprocal Protection of Investment (US 2004 Model BIT): <<http://www.state.gov/documents/organization/38710.pdf>>.

<sup>111</sup> Andrea J Menaker, 'Benefiting from Experience: Developments in the United States' Most Recent Investment Agreements' (2005–06) 12 *UC Davis J Int'l L & Pol'y* 121; *Bilateral Investment Treaties 1995–2006*, *supra* n 91 at xiii, 92–9.

in the IIA. Investor-host state arbitration results in a legally binding award. Investor-state arbitration provisions began to appear in BITs in the late 1960s, after the entry into force of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention) in 1966, and they are now found in most BITs.<sup>112</sup> The ICSID Convention provides for international arbitration of legal disputes arising out of investments when both the host state and the national state of the investor are ICSID contracting parties.<sup>113</sup> Canada signed the ICSID Convention on 15 December 2006, but ratification is unlikely until the federal and provincial/territorial governments pass implementing legislation.<sup>114</sup>

Most BITs concluded in recent years provide a choice of international arbitration rules, such as those in the ICSID Convention, the ICSID Additional Facility Rules or the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules.<sup>115</sup> Often, these arbitration rules provide the numerous details governing the conduct of the arbitral process. While many BITs do not require prior exhaustion of local remedies and allow the investor to go directly to arbitration in the event of a dispute, some BITs require the investor to first exhaust local remedies or resort to domestic courts for a specified period of time.<sup>116</sup> Some BITs also include a governing law clause in which the parties have agreed on the substantive law to govern the dispute.<sup>117</sup>

Since the 1990s, with the explosion in the number of IIAs and consequential investor-state disputes, the ICSID arbitration process has been used frequently.<sup>118</sup> The ICSID Convention obligates all its state parties to recognise the binding nature of ICSID arbitral awards and enforce them if requested as if they were final domestic court judgements.<sup>119</sup> Only the ICSID Convention annulment mechanism can be used by a disputing party to try to prevent the award from being enforced.<sup>120</sup> Many investor-state disputes have been arbitrated under other international arbitration rules. With these rules, resulting arbitral awards can be enforced in states that are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.<sup>121</sup>

More new BITs, in particular those entered into by the United States and Canada, have included new types of dispute settlement provisions to address both civil society complaints

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<sup>112</sup> Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (ICSID Convention), 575 *UNTS* 159; (1965) 4 *ILM* 524 (signed 18 March 1965, in force 14 October 1966); *ibid* at 100; Van Harten, *supra* n 73 at 25.

<sup>113</sup> ICSID Convention, *ibid*. While written consent to submit an investment dispute to ICSID arbitration may be made by the parties in an investment contract or an *ad hoc* agreement, many state parties have given their written consent to ICSID arbitration in advance in IIAs.

<sup>114</sup> By November 2008 there were 143 ICSID Contracting States: <<http://www.icsid.worldbank.org>> ('List of Contracting States'). By 2008, Ontario, British Columbia, Saskatchewan, Newfoundland, Nunavut and the Federal Government had passed implementing legislation.

<sup>115</sup> *Bilateral Investment Treaties 1995–2006*, *supra* n 91 at 100, 110–13. The ICSID Additional Facility Rules can be used when only one of the relevant states — the host state or the investor state — is an ICSID Convention party.

<sup>116</sup> *Ibid* at 108–9.

<sup>117</sup> *Ibid* at 115–16.

<sup>118</sup> See *infra* n 133.

<sup>119</sup> ICSID Convention, *supra* n 112, Art 54.

<sup>120</sup> *Ibid* Art 52. Annulment of the award will only be successful if one of the listed procedural flaws or corruption on the part of a member of the arbitral tribunal is found.

<sup>121</sup> (1958) 330 *UNTS* 3 (NY Convention).

and host government concerns.<sup>122</sup> These increase transparency of the arbitral process and hearings and facilitate third party participation.<sup>123</sup> The phenomenon of inconsistent holdings in arbitral awards that were founded on very similar or identical facts led the United States to require in its most recent model BIT that the state parties consider the establishment of an appellate body to review awards applying the BIT.<sup>124</sup>

### **xxxix. Fluctuating Latin American State Attitudes to International Investment Law**

#### **Historical Changes**

From the second half of the nineteenth century, Latin American states followed the Calvo doctrine, based on the writings of the Argentinian jurist, Carlos Calvo.<sup>125</sup> The doctrine emphasised Latin American state sovereignty, non-intervention in their affairs and the equality of treatment of domestic and international investors under the domestic law of the host state. The doctrine was applied in investment contracts with Latin American governments in the guise of the ‘Calvo’ clause in which the foreign investor waived its right to diplomatic protection and international settlement of disputes, and agreed to settle investment disputes in the domestic legal system of the host state.<sup>126</sup>

Latin American states started to loosen their ties to the Calvo doctrine in the mid-twentieth century, entering into some FCN treaties starting in the 1950s, and signing a few BITs starting in 1959.<sup>127</sup> The economic and political changes of the 1980s described earlier led to greater interest in attracting FDI as foreign credit flows dried up. Starting in the 1980s, many Latin American and Caribbean states entered into BITs with industrialised states and with states from the same region.<sup>128</sup>

Similarly, Latin American states were also opposed to the ICSID Convention from its inception in 1965 into the 1970s; the first Latin American state to become bound by the ICSID Convention was Paraguay (1983), with other accessions following in the 1980s and 1990s.<sup>129</sup> By November 2008, just over two-thirds of the states in the Americas were parties

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<sup>122</sup> *Bilateral Investment Treaties 1995–2006*, *supra* n 91 at xiii, 119–26.

<sup>123</sup> *Ibid* at 119–26; Menaker, *supra* n 111 at 124–8; J Anthony VanDuzer, ‘Enhancing the Procedural Legitimacy of Investor-State Arbitration Through Transparency and *Amicus Curiae* Participation’ (2007) 52 *McGill LJ* 681.

<sup>124</sup> US 2004 Model BIT, *supra* n 110, Annex D; Menaker, *ibid* at 128–9; *Bilateral Investment Treaties 1995–2006*, *supra* n 91 at 124: ‘[I]f the main purpose of an appellate mechanism is to ensure consistency in arbitral awards, it should bring under its umbrella most, if not all, existing BITs and other [IIAs]. However, such an outcome could not be achieved by an appellate mechanism established by only one or several bilateral agreements’; on inconsistent arbitral awards see Franck, *supra* n 91.

<sup>125</sup> See Paul Peters and Nico Schrijver, ‘Latin America and International Regulation of Foreign Investment: Changing Perceptions’ (1992) 39 *Neth Int’l L Rev* 355, 355–64.

<sup>126</sup> Donald R Shea, *The Calvo Clause: A Problem of Inter-American and International Law and Diplomacy* (1955).

<sup>127</sup> Peters and Schrijver, *supra* n 125 at 368–70; ICSID Databases of BITs: <<http://www.icsid.worldbank.org>>; see, for example, 1959 Dominican Republic–West Germany BIT; 1965 Costa Rica–Switzerland BIT; 1965 Ecuador–West Germany BIT.

<sup>128</sup> ICSID Databases of BITs, *ibid*. Although the ICSID database disclaims comprehensiveness, it is illustrative of the number of states in the Americas that have entered into BITs (only Bahamas and St Kitts do not have any BITs listed) and the large numbers of BITs ratified by some Latin American states. In contrast, Caribbean states have entered into fewer BITs.

<sup>129</sup> Paul C Szasz, ‘The Investment Disputes Convention and Latin America’ (1970–1) 11 *Va J Int’l L* 256; ICSID, ‘List of Contracting States’, *supra* n 114. A few Caribbean nations became ICSID member states early

to the ICSID Convention and most states had ratified the Multilateral Investment Guarantee Agency (MIGA) Convention, the international organisation providing political risk insurance to cover developed member-state FDI in developing member states.<sup>130</sup>

Some states are unwilling to be bound by these two multilateral treaties. Cuba and Mexico are not parties to either, although Mexico is in the process of fulfilling its MIGA membership requirements.<sup>131</sup> Brazil has not signed the ICSID Convention, although it is an MIGA member state. Although Brazil has signed around fourteen BITs, the country's legislature has refused to ratify them, leaving foreign investors to rely on the terms of any investment contract and the Brazilian domestic legal system.<sup>132</sup>

### c. Recent Reverses

However, cracks are starting to appear in the Latin American relationship with the ICSID Convention. Currently, a small number of Latin American states are respondents in a large number of pending ICSID arbitration claims. By late November 2008, with 124 pending ICSID arbitral cases internationally, Argentina faced 35 claims, largely as a result of its responses in dealing with its 2001–02 economic crisis. Ecuador was the respondent in eight arbitrations, Venezuela in six, Mexico in five, Peru in four and Costa Rica in three.<sup>133</sup> More generally, of these total pending arbitral claims, 67 claims (about 54%) were against Latin American states and only one involved a Caribbean nation.

As a result of its treatment of foreign investors in the energy sector over the past few years, Ecuador has faced and continues to confront a number of international investment arbitral claims under both ICSID and other international arbitral rules.<sup>134</sup> Argentina has delayed the enforcement of ICSID awards rendered against it by invoking the annulment mechanism; some claims have been settled and others have been suspended pending negotiation settlements.<sup>135</sup> Questions have been raised whether Argentina will ultimately pay any large damages awards rendered against the state.<sup>136</sup>

on (for example, Jamaica (1966), Trinidad and Tobago (1967) and Guyana (1969)) with others acceding starting in the 1980s.

<sup>130</sup> ICSID 'List of Contracting States', *ibid*; MIGA, 'About MIGA' (2008): <<http://www.miga.org>>. States that have not signed or who have withdrawn from the ICSID Convention are Antigua and Barbuda, Bolivia, Brazil, Cuba, Dominica, Mexico and Suriname. Belize, Canada, the Dominican Republic and Haiti have signed but not ratified the Convention. Canada is a MIGA member state and, as a developed state, Canadian investors can obtain MIGA investment insurance to cover political risks affecting their FDI in developing MIGA states.

<sup>131</sup> 'About MIGA', *ibid* (November 2008). But, for example, Mexico is a party to NAFTA Ch 11 and other trade agreements, some of which have investment chapters: see McGill Preferential Trade Agreements Database, *supra* n 61.

<sup>132</sup> ICSID Databases of BITs, *supra* n 127; Barbosa, *supra* n 76 at 1022; *supra* text accompanying n 90.

<sup>133</sup> ICSID, 'Pending Cases' (27 November 2008): <<http://www.icsid.worldbank.org>>. Looking at the 146 ICSID arbitral 'Concluded Cases' (late 1966 to 27 November 2008), *ibid*, only 42 involved Latin American states and seven involved Caribbean nations (with Argentina (13), Mexico (9), Venezuela (5), Ecuador (5), Peru (3) and Jamaica (3) involved in the largest numbers of claims), although 25 (60%) of these were settled or discontinued, especially in claims against Argentina. On the Argentine economic crisis and the government's response, for example, investments/income currency changed from dollar-pegged to devalued pesos, resulting in over US\$16 billion in arbitral claims, see Van Harten, *supra* n 73 at 2–3; *infra* text accompanying nn 269–74.

<sup>134</sup> Cadena and Montañes, *supra* n 67. See *infra* text accompanying nn 259–68 on the *Occidental* and *EnCana* arbitral claims against Ecuador.

<sup>135</sup> See ICSID, 'Pending Cases', *supra* n 133.

<sup>136</sup> For example, *Azurix Corp v Argentine Republic*, *ibid*, decision on the Argentine Republic's Request for a Continued Stay of Enforcement of the Award (28 December 2007) (2008) 47 *ILM* 448 para 15(h) (investor

Bolivia, Ecuador and Venezuela have also taken steps to withdraw from their international investment law commitments. In May 2007, Bolivia announced that it was withdrawing from the ICSID Convention.<sup>137</sup> In November 2007, Ecuador notified ICSID under Art 25(4) of the ICSID Convention that it 'will not consent to submit to the jurisdiction [of ICSID] the disputes that arise in matters concerning the treatment of an investment resulting from economic activities related to the exploitation of natural resources, such as oil, gas, minerals or others'.<sup>138</sup> In early 2008 Ecuador stated that it intended to terminate its BIT relationships with nine, mainly Latin American, countries and planned to renegotiate 13 others.<sup>139</sup> Ecuador is forcing foreign companies to renegotiate their contracts with clauses that waive the right to submit to ICSID arbitration, and its 2008 Constitution prohibits the government from entering into treaties containing investor-state arbitration clauses unless a Latin American venue is used.<sup>140</sup> In late 2008, Venezuela decided to withdraw from its BIT with the Netherlands.<sup>141</sup> Venezuela and Nicaragua have threatened to withdraw from the ICSID Convention.<sup>142</sup> Also, Ecuador, Bolivia and Argentina are promoting the idea of a regional dispute settlement mechanism, presumably to be used instead of ICSID.<sup>143</sup>

## **23. IIAs Between Canada and Latin American/Caribbean States**

### **xl. Canada: From FCN Treaties to FIPAs (BITs)**

The evolution of international law discussed above can also be seen in the Canadian context. After early methods of diplomatic protection, Canada became a party to some bilateral FCN treaties entered into by the United Kingdom on behalf of Canada or directly by Canada after it assumed responsibility for entering into treaties.<sup>144</sup> Compared to Western European states,

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argued there is little chance Argentina will pay any damages awarded in future since government officials have stated that the country will not comply with ICSID awards but will challenge them in domestic and international tribunals); para 39 (in granting stay, annulment committee notes no history of non-payment of ICSID awards).

<sup>137</sup> ICSID Convention, *supra* n 112; ICSID News Release, *Bolivia Submits a Notice Under Article 71 of the ICSID Convention* (16 May 2007); Marco Tulio Montañes, 'Introductory Note to Bolivia's Denunciation of the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States' (2007) 46 *ILM* 969. The denunciation took effect on 3 November 2007. BITs, however, often provide for international arbitration under other rules.

<sup>138</sup> Cadena and Montañes, *supra* n 67 at 154–5.

<sup>139</sup> *Ibid* at 156; *UNCTAD World Investment Report 2008*, *supra* n 62 at 65.

<sup>140</sup> Ecuador 2008 Constitution Art 422: <<http://www.presidencia.gov.ec/modulos.asp?id=109>>; Cadena and Montañes, *ibid* at 155–6; Fernando Cabrera Diaz, 'Ecuador Threatens Cancellation of Oil Contracts Unless ICSID Nixed as Arbitration Forum', International Institute for Sustainable Development, *Investment Treaty News*, 29 August 2008.

<sup>141</sup> 'Venezuela Pulls out of BIT with Netherlands', 18 November 2008, *Global Arb Rev*, (too many foreign investors incorporating in the Netherlands to take advantage of the BIT's terms).

<sup>142</sup> American Society of International Law, 'Bolivia's Denunciation of the ICSID Convention', *International Law in Brief*, 27 July 2007; *UNCTAD World Investment Report 2008*, *supra* n 62 at 65.

<sup>143</sup> Cadena and Montañes, *supra* n 67 at 157.

<sup>144</sup> See, for example, FCNs entered into by the United Kingdom for Canada (for example, with Colombia, Argentina, Venezuela, Peru); Edward G Lee, 'Canadian Practice in International Law During 1973 as Reflected Mainly in Public Correspondence and Statements of the Department of External Affairs' (1974) 12 *Can Yb Int'l Law* 272, 277; Carswell, *International Trade and Investment Law in Canada* at 10–8. See Tinoco and IPC affairs, *supra* nn 9, 18, for situations where early Canadian foreign investment disputes settled, and *Barcelona Traction* case, *supra* n 12, paras 76–78, 100 for an example of where the Canadian Government halted its diplomatic protection of the company.

and even to the United States, which completed its first BIT negotiation in 1982,<sup>145</sup> Canada was a relative laggard when it came to entering into BITs, and then called them ‘foreign investment promotion and protection agreements’ (FIPAs).

Major changes made in Canada’s international investment policies in the 1980s led to the launch of Canada’s FIPA program.<sup>146</sup> Canada signed its first FIPA with the USSR on 20 November 1989, although the FIPA with Poland was the first to enter into force, in late 1990.<sup>147</sup> While Canada entered into a number of FIPAs in the 1990s, there was a seven-year hiatus in FIPA negotiation until the Federal Government renewed the initiative in late 2006 and also turned to the negotiation of FTAs containing investment chapters.<sup>148</sup> With respect to the latter, the Canadian Government appears to have followed in the footsteps of the United States Government which has negotiated numerous bilateral FTAs containing investment chapters during the George W Bush administration.<sup>149</sup>

By late November 2008, Canada had FIPAs in force with 23 states;<sup>150</sup> another four FIPAs negotiated but not yet in force;<sup>151</sup> seven FIPAs being negotiated;<sup>152</sup> two bilateral FTAs in force with investment chapters;<sup>153</sup> two bilateral FTAs with investment chapters signed but not

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<sup>145</sup> Jeswald W Salacuse, ‘BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries’ (1990) 24 *Intl L* 655.

<sup>146</sup> Robert Paterson, ‘Canadian Investment Promotion and Protection Treaties’ (1991) 29 *Can YB Int’l L* 373, 375.

<sup>147</sup> Canada-USSR FIPA (signed 20 November 1989, entered into force 27 June 1991, CTS 1991/31); Canada-Poland FIPA (signed 6 April 1990, entered into force 22 November 1990, CTS 1990/43).

<sup>148</sup> Although negotiations for a FTA with four Central American states were launched by the Liberal Government in 2001: Danielle Goldfarb, ‘US Bilateral Free Trade Accords: Why Canada Should be Cautious About Going the Same Route’, *The Border Papers*, DC Howe Institute Commentary No 214 (August 2005) 6.

<sup>149</sup> See, for example, Jaime Granados and Rafael Cornejo, ‘Convergence in the Americas: Some Lessons From the DR-CAFTA Process’ (2006) *The World Economy* 857; David A Gantz, ‘Settlement of Disputes Under the Central America-Dominican Republic-United States Free Trade Agreement’ (2007) 30 *BC Int’l & Comp L Rev* 331; Gagné and Morin, *supra* n 110; Goldfarb, *ibid*; William B P Robson, ‘Stuck on a Spoke: Proliferating Trade Deals are a Dangerous Game for Canada’ (16 August 2007) *CD Howe Institute e-brief*.

<sup>150</sup> Counting the Czech and Slovak Republic FIPA as applicable to two separate states, Canada has FIPAs in force with Poland, *supra* n 147; USSR (now Russia), *supra* n 147; Czech Republic, Slovak Republic (signed 15 November 1990, in force 9 March 1992, CTA 1992/10); Argentina (signed 15 November 1991, in force 29 April 1993, CTS 1993/11); Hungary (signed 3 October 1991, in force 21 November 1993, CTS 1993/14); Ukraine (signed 24 October 1994, in force 24 July 1995, CTS 1995/23); Latvia (signed 26 April 1995, in force 27 July 1995, CTS 1995/19); Trinidad and Tobago (signed 11 September 1995, in force 8 July 1996, CTS 1996/22); Philippines (signed 9 November 1995, in force 13 November 1996, CTS 1996/46); Barbados (signed 29 May 1995, in force 17 January 1997, CTS 1997/4); Romania (signed 1996, in force 11 February 1997, CTS 1997/47); Ecuador (signed 29 April 1996, in force 6 June 1997, CTS 1997/25); Egypt (signed 13 November 1996, in force 3 November 1997, CTS 1997/31); Venezuela (signed 1 July 1996, in force 28 January 1998, CTS 1998/20); Panama (signed 12 September 1996, in force 13 February 1998, CTS 1998/35); Thailand (signed 17 January 1997, in force 24 September 1998, CTS 1998/29); Armenia (signed 8 May 1997, in force 19 March 1999, CTS 1999/22); Uruguay (signed 29 October 1997, in force 2 June 1999, CTS 1999/31); Lebanon (signed 11 April 1997, in force 19 June 1999, CTS 1999/15); Costa Rica (signed 18 March 1998, in force 29 September 1999, CTS 1999/43); Croatia (signed 1997, in force 20 January 2001, CTS 2001/4); Peru (signed 14 November 2006, in force 20 June 2007). See on-line: <[http://www.international.gc.ca/tna-nac/fipa\\_list\\_en.asp](http://www.international.gc.ca/tna-nac/fipa_list_en.asp)>.

<sup>151</sup> Canadian FIPAs with India (negotiations concluded 16 June 2007); Jordan (negotiations concluded June 2007); El Salvador (signed 31 May 1999); and South Africa (signed 27 November 1995).

<sup>152</sup> FIPA negotiations are underway with Vietnam, Mongolia, China, Indonesia, Kuwait, Madagascar and Tanzania.

<sup>153</sup> NAFTA, Ch 11, *supra* n 22 (in force 1 January 1994); Canada-Chile Free Trade Agreement (1997) 36 *ILM* 1079, Ch G (in force 5 July 1997). The Canada-Costa Rica and Canada-Israel FTAs do not contain investment chapters.

yet in force;<sup>154</sup> and more FTA negotiations underway, of which most, if not all, include investment and could cover more than 20 new countries.<sup>155</sup>

## **xli. Scope of Coverage**

### **Overview**

Focusing on Latin America and the Caribbean, by late November 2008 Canada had FIPAs in force with nine countries: Argentina, Trinidad and Tobago, Barbados, Ecuador, Venezuela, Panama, Uruguay, Costa Rica and Peru.<sup>156</sup> Canada has four FTA investment chapters in force or signed with countries in the Americas: NAFTA Ch 11 (the IIA for Canada-Mexico investment flows); the Canada-Chile Free Trade Agreement Ch G; and investment chapters in both the new Canada-Peru and Canada-Colombia FTAs.<sup>157</sup> The Canadian Government is currently engaged in FTA negotiations including investment coverage with (1) the CA4 states of El Salvador, Guatemala, Honduras and Nicaragua;<sup>158</sup> (2) the Dominican Republic;<sup>159</sup> (3) CARICOM (14 Caribbean states and one British overseas territory);<sup>160</sup> and (4) Panama.<sup>161</sup>

### **d. Present Coverage and Future Prospects**

By late November 2008, Canada had FIPAs and FTA investment chapters in force with 11 of the 33 Latin American and Caribbean states, and the investment chapters in the Canada-Peru and Canada-Colombia FTAs should enter into force in the future to provide IIA coverage for a total of 12 states in the region (Annex 1). Canada has not signed an FIPA with Brazil, the country in which the largest amount of Canadian outward FDI in Latin America is located. As discussed earlier, since Brazil has not ratified any of the BITs it has signed over the years it is unrealistic to expect that Canada could obtain a ratified FIPA with Brazil in the near future. Canada also does not have active IIA coverage to date protecting Canadian OFDI in Paraguay, Bolivia, El Salvador, Honduras, Nicaragua, Guatemala, Dominican Republic, Cuba, most of the CARICOM members and the British overseas territories receiving substantial Canadian OFDI.

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<sup>154</sup> Canada-Peru FTA (signed 29 May 2008): <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/andean-andin/can-peru-perou.aspx>>; Canada-Colombia FTA (signed 21 November 2008): <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/andean-andin/can-colombia-colombie.asp>>. FTA negotiations with Jordan concluded on 25 August 2008 (see separate Canada-Jordan FIPA, FTA text not public at date of writing). A Canada-European Free Trade Association (EFTA) FTA was signed on 26 January 2008 (does not include an investment chapter).

<sup>155</sup> FTA negotiations are on-going with Dominican Republic; CARICOM (with 15 members); South Korea; Central American Four (CA4) states; Singapore; and Panama (all include investment negotiations).

<sup>156</sup> *Supra* n 150. Canada also signed a BIT with El Salvador in 1999 which has not entered into force to date, the delay likely due to the on-and-off FTA negotiations between Canada and the CA4 states.

<sup>157</sup> NAFTA, *supra* n 22; Canada-Chile Free Trade Agreement, *supra* n 153; Canada-Peru FTA, *supra* n 154; Canada-Colombia FTA, *supra* n 154.

<sup>158</sup> FTA negotiations with the CA4 states started in 2001, and there have been periodic negotiations and meetings since then without any success to date.

<sup>159</sup> FTA negotiations with the Dominican Republic were launched on 7 June 2007, *supra* text accompanying n 45.

<sup>160</sup> FTA negotiations with CARICOM were started on 19 July 2007. See *supra* n 36 for CARICOM members (Montserrat is a British overseas territory). On Canadian FDI in CARICOM states see *supra* text accompanying nn 40–6.

<sup>161</sup> <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/panama/index.aspx>>. See existing Canada-Panama FIPA, *supra* n 150.

While growing, the current number of Canadian IIAs in the region is relatively modest in relation to the total number of states and overseas territories, covering just over one-third of the independent states. However, from other perspectives, Canada does have IIAs in force or signed with most of the states in the region with the largest economies, and with many of the states where there are substantial flows of Canadian OFDI: Barbados, Chile, Mexico, Argentina, Peru, Trinidad and Tobago, Venezuela and Colombia.<sup>162</sup> Nonetheless, there are high levels of Canadian OFDI moving into countries or jurisdictions where there is no IIA protecting Canadian investors: Brazil, the Bahamas, Dominican Republic, Cayman Islands and Bermuda, although there are ongoing FTA negotiations including investment with CARICOM (includes the Bahamas) and the Dominican Republic.

Comparing United States and Canadian IIA activity in the region, by late November 2008 the United States had FTAs with 11 countries in Latin America and the Caribbean, all of which contain investment chapters (although not all in force), and has an additional nine BITS in force with countries in the region, two of which overlap with negotiated FTA chapters (Annex 2).<sup>163</sup> Thus, at this point in time Canadian investors and OFDI are slightly less protected by IIAs in the region compared to United States investors/OFDI, and the United States has a higher number of FTA investment chapters in the region compared to Canada. However, if some or all of Canada's FTA negotiations with the Dominican Republic, CARICOM and CA4 bear fruit, Canada will increase its IIA network of protection in both absolute and comparative terms (Annex 3).

As the United States has increased its FTA investment chapter relationships in the region since 2000, Canada has also begun to favour FTA investment chapter negotiation over FIPAs in Latin America and the Caribbean (Annexes 1, 3). Commentators have noted how the growth in bilateral FTAs in the Western hemisphere has been driven by a small number of states; for example, the United States, Mexico and Chile, with the result that they become 'hubs', attracting more trade activity than other states located at the ends of the 'spokes'.<sup>164</sup> As FTAs in the region increasingly include investment chapters, this phenomenon could potentially be duplicated with international investment flows, at least on a short-term basis.<sup>165</sup> The growth in the number of Canadian FTAs with investment chapters in Latin America and the Caribbean can also be seen as an attempt to add Canada to the hub states in the region. While some commentators have criticised the growth of bilateral FTAs for weakening the

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<sup>162</sup> See 2007 Canadian OFDI statistics, *supra* text accompanying nn 28–39.

<sup>163</sup> By November 2008, the United States had FTAs with Mexico (and Canada); Chile; Peru (pending implementation); Dominican Republic and the Central American states of Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua (CAFTA-DR) (entry into force for Costa Rica expected 1 January 2009); Colombia (pending congressional approval) Panama (pending congressional approval), all with investment chapters. In the region by the same date, the United States had BITS in force with Argentina, Bolivia, Ecuador, Grenada, Honduras, Jamaica, Panama, Trinidad and Tobago and Uruguay. It has BITS signed but not in force with El Salvador, Haiti and Nicaragua. For United States FTAs see Office of the Trade Representative: <[http://www.ustr.gov/Trade\\_Agreements/Section\\_Index.html](http://www.ustr.gov/Trade_Agreements/Section_Index.html)>; for United States BITS see Department of State: <<http://www.state.gov/e/eeb/rls/fs/2008/22422.htm>>.

<sup>164</sup> Granados and Cornejo, *supra* n 149 at 864.

<sup>165</sup> More empirical research is needed to determine whether FTA investment chapters attract FDI over time, but see findings that although FDI flows into Mexico did increase significantly in the years immediately following NAFTA's entry into force these levels dropped off by the late 1990s, with little evidence that NAFTA led to FDI diversion into Mexico from other states in the region: David Lederman, William F Maloney and Luis Servén, *Lessons from NAFTA for Latin America and the Caribbean* (2005) 18, 195–6. In contrast, see research on FDI diversion effect of BITS, *supra* n 88.

multilateral trade system,<sup>166</sup> paradoxically, the increase in the number of bilateral FTA investment chapters broadens the legal protections offered to Canadian investors in Latin America, the Caribbean and beyond, in a system with no multilateral regime to be weakened.

### **xlii. Canada's IIAs with Latin American and Caribbean States**

Canada's IIAs have followed three increasingly complex models: the early Organisation for Economic Co-operation and Development (OECD) model; the NAFTA model; and the most recent 2004 FIPA model.

#### **OECD Model IIAs: Argentina**

FIPAs entered into before the NAFTA era were based on a relatively simple OECD-based model BIT.<sup>167</sup> Looking at Canada's IIAs with Latin American and Caribbean states, only the Canada-Argentina FIPA (1993) is based on this model. It does not provide for the right of establishment of investment, and allows the host state to apply laws restricting the establishment of foreign investment or the acquisition of domestic businesses by a foreign investor, as long as these laws are applied equally to all foreign investors.<sup>168</sup> While it contains many of the standard BIT obligations, the Canada-Argentina FIPA does so in relatively simple terms; for example, a non-exhaustive definition of 'investment'; and the obligations of fair and equitable treatment, MFN, national treatment and expropriation.<sup>169</sup> The use of 'investment treaty shopping', where the investor uses the MFN principle to receive the benefit of more advantageous provisions in other BITs to which the host state is bound, is available to a certain degree in the Canada-Argentina FIPA, because the MFN treatment obligation is only excluded with respect to existing or future FTAs or other economic integration agreements — other BITs are not expressly excluded.<sup>170</sup> The expropriation provision covers both direct and indirect expropriation and requires that compensation be prompt, adequate and effective.<sup>171</sup> However, the FIPA does not include provisions prohibiting performance requirements, limiting the coverage of the agreement with respect to taxation matters or excluding sectors (for example, cultural industries) from coverage.

The early model FIPA provisions on host state-investor dispute settlement permit the investor to submit the dispute to international arbitration if it cannot be resolved amicably within a six-month period.<sup>172</sup> However, the model applies only the UNCITRAL Arbitration Rules to the arbitral process.<sup>173</sup> In contrast, at the time the Canada-Argentina FIPA was negotiated, Argentina was beginning to push away from the Calvo clause. As a result, the FIPA permits investor-state international arbitration for the settlement of disputes 'which arise within the

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<sup>166</sup> Goldfarb, *supra* n 148; Robson, *supra* n 149.

<sup>167</sup> Foreign Affairs and International Trade Canada: <[http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fipa-apie/fipa\\_LIST.aspx?lang=en](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fipa-apie/fipa_LIST.aspx?lang=en)>; E Michael Power, *Foreign Investment Protection Agreements: A Canadian Perspective* (No 14, Ottawa: Investment Canada, 1993) (OECD model FIPA in Annex A).

<sup>168</sup> Canada-Argentina FIPA, *supra* n 150, Art II(1)–(3); early model FIPA, *ibid*, Art II(1)–(3).

<sup>169</sup> Canada-Argentina FIPA, *ibid*, Arts I, II(4), III–VIII; early model FIPA, *ibid*, Arts I, II(4), III–VIII. The national treatment provision is qualified, does not use a comparator of domestic investors 'in like circumstances' and does not address the obligation as applied to sub-national units.

<sup>170</sup> Canada-Argentina FIPA, *ibid*, Art V; early model FIPA, *ibid*, Art V.

<sup>171</sup> Canada-Argentina FIPA, *ibid*, Art VII(1); early model FIPA, *ibid*, Art VII(1).

<sup>172</sup> Early model FIPA, *ibid*, Art X(1)–(2). The clause is silent on most other details of the arbitral process including enforcement aspects of any resulting arbitral award.

<sup>173</sup> *Ibid* Art X(3).

terms of [the FIPA]' only after the parties use the domestic courts of the host state for a specified period of time or where the parties agree to go directly to international arbitration.<sup>174</sup> It is questionable whether Canadian investors wishing to go directly to international arbitration can attempt to use dispute settlement provisions in other BITs entered into by Argentina that permit direct access to international arbitration via the MFN clause in the Canada-Argentina FIPA.<sup>175</sup> Where international arbitration does occur, the Canada-Argentina FIPA is more flexible than the model, stating that the ICSID, ICSID Additional Facility or UNCITRAL Arbitration Rules can be selected, although only the latter two options are currently available to Canadian investors.<sup>176</sup> The law to be applied by the arbitrators is a combination of domestic and international law sources: the FIPA terms; the terms of any relevant investment contract; the laws of the host state; and principles of international law.<sup>177</sup> Under the Canada-Argentina FIPA, disputes between the two contracting states over the interpretation or application of the FIPA will ultimately be decided by binding international arbitration, although the FIPA is silent on enforcement aspects.<sup>178</sup> The Canada-Argentina FIPA can be terminated by either party after one year's notice, but where investments or commitments to invest have been made before the FIPA is terminated, the substantive and dispute settlement obligations in the FIPA remain in force for 15 years.<sup>179</sup>

**e. NAFTA Model IIAs: Mexico, Chile, Trinidad and Tobago, Barbados, Ecuador, Venezuela, Panama, Uruguay and Costa Rica**

Since the negotiation of NAFTA Ch 11 (governing *inter alia* Canada-Mexico investment flows), the Canada-Chile FTA Ch G and FIPAs in force with Trinidad and Tobago (1996), Barbados (1997), Ecuador (1997), Venezuela (1998), Panama (1998), Uruguay (1999) and Costa Rica (1999) are based on the more complex NAFTA Ch 11 model.<sup>180</sup> With NAFTA and the Canada-Chile FTA, the definition of covered 'investment' is broad and asset-based, but is exhaustive and subject to listed exceptions ('closed-list').<sup>181</sup> The FIPAs, however, continue to use a non-exhaustive definition of investment, with listed exceptions.<sup>182</sup> Host state obligations permitting establishment of investment appear in the NAFTA and the Canada-Chile FTA, subject to reservations and exclusions, including from dispute

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<sup>174</sup> Canada-Argentina FIPA, *supra* n 150, Art X(1)–(2) (other early Canadian FIPAs limited the disputes going to disputes settlement to specified obligations). If one of the parties wishes to use the courts of the host state and they have not both agreed to go to international arbitration, the domestic courts must be resorted to for up to 18 months if the tribunal has not given its decision by that time or until the final decision of the court has been made but the parties are still in dispute.

<sup>175</sup> *Ibid* Arts III, V, *supra* text accompanying n 170; Power, *supra* n 167 at 12, argued Canadians can use 1991 US-Argentina BIT Art VII, *supra* n 163. But see *Wintershall Aktiengesellschaft v Argentina*, ICSID Case No ARB/04/14, Award on Jurisdiction (8 December 2008), where investor unsuccessfully tried to use MFN clause in Germany-Argentina BIT to avoid use of that BIT's requirement that domestic courts be used first (very similar to wording in Canada-Argentina BIT) in favour of Art VII of the United States-Argentina BIT.

<sup>176</sup> *Ibid* Art X(3); *supra* n 113.

<sup>177</sup> *Ibid* Art X(4).

<sup>178</sup> *Ibid* Art XII(5); OECD model FIPA, *supra* n 167.

<sup>179</sup> *Ibid* Art XV(2); early model FIPA, *ibid* Art XV(2).

<sup>180</sup> *Supra* n 150.

<sup>181</sup> NAFTA, *supra* n 22, Art 1139; Canada-Chile FTA, *supra* n 153, Art G-40.

<sup>182</sup> Canada-Trinidad and Tobago FIPA, *supra* n 150, Art I(f); Canada-Barbados FIPA, *supra* n 150, Art I(f); Canada-Ecuador FIPA, *supra* n 150, Art I(g); Canada-Venezuela FIPA, *supra* n 150, Art I(f); Canada-Panama FIPA, *supra* n 150, Art I(g); Canada-Uruguay FIPA, *supra* n 150, Art I(d); Canada-Costa Rica FIPA, *supra* n 150, Art I(g).

settlement.<sup>183</sup> An equivalent approach is taken in most of the FIPAs via separate provisions on establishment and acquisition of investment.<sup>184</sup> However, the Canada-Venezuela FIPA contains a more limited establishment clause.<sup>185</sup>

The various BIT obligations appear in more rigorous and detailed form in these IIAs: minimum standard of treatment (fair and equitable treatment) under international law; MFN treatment; national treatment (with both the MFN and national treatment obligations now using an ‘in like circumstances’ comparative standard); expropriation; compensation for losses; and transfer of funds.<sup>186</sup> Investment treaty shopping possibilities continue to be partially available in this generation of IIAs because the MFN treatment obligation is only excluded with respect to existing or future FTAs or other economic integration agreements and not other BITs.<sup>187</sup> The wording of the minimum standard of treatment obligation in the two FTAs differs slightly from that in the FIPAs. Also, the NAFTA Free Trade Commission issued a binding interpretation in 2001 which clarified the meaning of the NAFTA’s minimum standard of treatment obligation. This interpretation stated that the international law standard to be used is limited to customary international law and breach of another provision of NAFTA or another treaty does not establish that the minimum standard of treatment obligation has been violated.<sup>188</sup>

With respect to the expropriation provision, NAFTA Art 1110 caused some initial, ultimately unsuccessful, debate over whether its additional term ‘measures tantamount to nationalization

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<sup>183</sup> NAFTA, *supra* n 22, Arts 1101(2), 1102–1104, 1108, 1138, Annex 1138.2, Annexes I–IV; Canada-Chile FTA, *supra* n 153, Arts G-02–G-04, G-08, G-39, Annex G-39.2.

<sup>184</sup> Canada-Trinidad and Tobago FIPA, *supra* n 150, Art II(1), (3)–(4); Canada-Barbados FIPA, *supra* n 150, Art II(1), (3)–(4); Canada-Ecuador FIPA, *supra* n 150, Art II(1), (3)–(4); Canada-Panama FIPA, *supra* n 150, Art II(1), (3)–(4); Canada-Uruguay FIPA, *supra* n 150, Arts II(1), III, Annex I, Arts I–III, VI; Canada-Costa Rica FIPA, *supra* n 150, Arts II(1), III, Annex I, Arts I–III, VI.

<sup>185</sup> Canada-Venezuela FIPA, *supra* n 150, Art II(1), (3), Annex, Art II(3).

<sup>186</sup> NAFTA, *supra* n 22, Arts 1102–1105, 1109, 1110; Canada-Chile FTA, *supra* n 153, Arts G-02–G-05, G-09, G-10; Canada-Trinidad and Tobago FIPA, *supra* n 150, Arts II(2), III, IV, VII, VIII, IX; Canada-Barbados FIPA, *supra* n 150, Arts II(2), III, IV, VII, VIII, IX; Canada-Ecuador FIPA, *supra* n 150, Arts II(2), III, IV, VII, VIII, IX; Canada-Venezuela FIPA, *ibid*, Arts II(2), III, IV, VI, VII, VIII; Canada-Panama FIPA, *supra* n 150, Arts II(2), III, IV, VII, VIII, IX; Canada-Uruguay FIPA, *supra* n 150, Arts II(2), III, IV, VII, VIII, IX; Canada-Costa Rica FIPA, *supra* n 150, Arts II(2), III, IV, VII, VIII, IX.

<sup>187</sup> Canada-Trinidad and Tobago FIPA, *ibid*, Art III(3); Canada-Barbados FIPA, *ibid*, Art III(3); Canada-Ecuador FIPA, *ibid*, Art III(3); Canada-Venezuela FIPA, *ibid*, Art III(3); Canada-Panama FIPA, *ibid*, Art III(3); Canada-Uruguay FIPA, *ibid*, Annex I, Art I; Canada-Costa Rica FIPA, *ibid*, Annex I, Art I. With the FTAs, there are, for example, exclusions of existing laws, sectors and activities from MFN coverage but no express exclusion of treatment by a state party under other BITs, FTAs, NAFTA: *ibid*, Arts 1101, 1103, 1108; Canada-Chile FTA, *ibid*, Arts G-01, G-03, G-08.

<sup>188</sup> NAFTA *ibid*, Art 1105(1) (‘Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security’); NAFTA Free Trade Commission, *Notes of Interpretation of Certain Chapter 11 Provisions* (31 July 2001), <[http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/nafta\\_commission.aspx](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/nafta_commission.aspx)>; Canada-Chile FTA, *ibid*, Art G-05(1); Canada-Trinidad and Tobago FIPA, *ibid*, Art II(2) (‘Each Contracting Party shall accord investments or returns of investors of the other Contracting Party (a) fair and equitable treatment in accordance with principles of international law; and (b) full protection and security’); Canada-Barbados FIPA, *ibid*, Art II(2); Canada-Ecuador FIPA, *ibid*, Art II(2); Canada-Venezuela FIPA, *ibid*, Art II(2); Canada-Panama FIPA, *ibid*, Art II(2); Canada-Uruguay FIPA, *ibid*, Art II(2); Canada-Costa Rica FIPA, *ibid*, Art II(2). In NAFTA, *United Parcel Service of America, Inc v Canada*, Award on the Merits (24 May 2007) (2007) 46 *ILM* 919, paras 182–184, the investor tried to use the NAFTA’s MFN clause to apply the standard in Canadian FIPAs rather than NAFTA Art 1105(1) but was unsuccessful because it did not supply sufficient information to support consideration of the claim.

or expropriation' could encompass host government measures that did not amount to indirect expropriation. However, the NAFTA-era FIPAs in the region maintain the early model language and apply only to direct expropriation or nationalisation and 'measures having an effect equivalent to nationalization or expropriation'; that is, indirect expropriation.<sup>189</sup> While NAFTA Art 1110 and the Canada-Chile FTA Art G-10 use a complex compensation standard founded on fair market value, the 'prompt, adequate and effective compensation' standard is used in all the FIPAs.<sup>190</sup> With this generation of IIAs, prohibitions on performance requirements make their appearance, although those in the Venezuela and Uruguay FIPAs are much more limited compared to the other NAFTA-model IIAs in the region.<sup>191</sup> However, in all the IIAs of this period in the region, the national treatment, MFN and prohibition of performance requirements obligations are subject to a list of exceptions or grand-fathering of existing inconsistent laws.<sup>192</sup>

These IIAs contain taxation provisions — while most tax measures are excluded from treaty protection, several tax measures taken by the host government still fall within the compass of the IIA; for example, those argued to be expropriatory or in breach of an investment contract unless the two contracting states promptly and jointly determine that there is no expropriation or breach.<sup>193</sup> Further, the NAFTA and Canada-Chile FTA taxation provisions bring additional government measures within the treaty's ambit.<sup>194</sup> Starting with this generation of Canadian IIAs in the region, cultural industries are excluded from coverage by the treaty.<sup>195</sup> These IIAs differ in the extent to which host governments can take measures to preserve financial safety

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<sup>189</sup> Céline Lévesque, 'Distinguishing Expropriation and Regulation under NAFTA Chapter 11: Making Explicit the Link to Property' in Kevin C Kennedy (ed), *The First Decade of NAFTA: The Future of Free Trade in North America* (2004) 293, 299–300; NAFTA, *ibid*, Art 1110(1); Canada-Chile FTA, *ibid*, Art G-10(1) uses the same language as NAFTA Art 1110(1). See Canada-Trinidad and Tobago FIPA, *ibid*, Art VIII; Canada-Barbados FIPA, *ibid*, Art VIII; Canada-Ecuador FIPA, *ibid*, Art VIII; Canada-Venezuela FIPA, *ibid*, Art VII; Canada-Panama FIPA, *ibid*, Art VIII; Canada-Uruguay FIPA, *ibid*, Art VIII; Canada-Costa Rica FIPA, *ibid*, Art VIII.

<sup>190</sup> NAFTA, *ibid*, Art 1110(2)–(6); Canada-Chile FTA, *ibid*, Art G-10(2)–(8); Canada-Trinidad and Tobago FIPA, *ibid*, Art VIII; Canada-Barbados FIPA, *ibid*, Art VIII; Canada-Ecuador FIPA, *ibid*, Art VIII; Canada-Venezuela FIPA, *ibid*, Art VII; Canada-Panama FIPA, *ibid*, Art VIII; Canada-Uruguay FIPA, *ibid*, Art VIII; Canada-Costa Rica FIPA, *ibid*, Art VIII.

<sup>191</sup> NAFTA, *ibid*, Arts 1106–1107; Canada-Chile FTA, *ibid*, Arts G-06–G-07, Annexes I–III; Canada-Trinidad and Tobago FIPA, *ibid*, Art V; Canada-Barbados FIPA, *ibid*, Art V; Canada-Ecuador FIPA, *ibid*, Art V; Canada-Venezuela FIPA, *ibid*, Art V; Canada-Panama FIPA, *ibid*, Art V; Canada-Uruguay FIPA, *ibid*, Arts V–VI; Canada-Costa Rica FIPA, *ibid*, Arts V–VI. The Canada-Venezuela FIPA only applies to nationality of senior management and does not contain prohibitions on performance requirements relating to, for example, the manufacture or export of goods produced by the foreign investment.

<sup>192</sup> NAFTA, *ibid*, Art 1108, Annexes I–IV; Canada-Chile FTA, *ibid*, Art G-08; Canada-Trinidad and Tobago FIPA, *ibid*, Arts III, IV, VI, Annex; Canada-Barbados FIPA, *ibid*, Arts III, IV, VI, Annex; Canada-Ecuador FIPA, *ibid*, Arts III, IV, VI, Annex; Canada-Venezuela FIPA, *ibid*, Art III, Annex; Canada-Panama FIPA, *ibid*, Arts III, IV, VI, Annex; Canada-Uruguay FIPA, *ibid*, Annex I; Canada-Costa Rica FIPA, *ibid*, Annex I.

<sup>193</sup> NAFTA, *ibid*, Art 2103; Canada-Chile FTA, *ibid*, Art O-03; Canada-Trinidad and Tobago FIPA, *ibid*, Art XII; Canada-Barbados FIPA, *ibid*, Art XII; Canada-Ecuador FIPA, *ibid*, Art XII; Canada-Venezuela FIPA, *ibid*, Arts XI; XII(14); Canada-Panama FIPA, *ibid*, Art XII; Canada-Uruguay FIPA, *ibid*, Arts VIII(3), XI, Annex II, Art II; Canada-Costa Rica FIPA, *ibid*, Arts VIII(3), XI. Beyond a tax measure in breach of an investment contract, this generation's IIAs do not contain general umbrella clauses: Boscarriol, *supra* n 91 at 132.

<sup>194</sup> NAFTA, *ibid*, Art 2103(3)–(6); Canada-Chile FTA, *ibid*, Art O-03(3)–(6).

<sup>195</sup> NAFTA, *ibid*, Art 2106, Annex 2106 (but potentially allowing retaliatory measures by other NAFTA states); Canada-Chile FTA, *ibid*, Art O-06, Annex O-06; Canada-Trinidad and Tobago FIPA, *supra* n 150, Art VI(3); Canada-Barbados FIPA, *supra* n 150, Art VI(3); Canada-Ecuador FIPA, *supra* n 150, Arts I(a), VI(3); Canada-Venezuela FIPA, *supra* n 150, Annex, Art II(9); Canada-Panama FIPA, *supra* n 150, Art VI(3); Canada-Uruguay FIPA, *supra* n 150, Annex I, Art III(4); Canada-Costa Rica FIPA, *supra* n 150, Art I(a), Annex I, Art III(4).

and measures to protect the environment and health.<sup>196</sup> Only the NAFTA and the Canada-Chile FTA expressly permit the host governments to take measures on the grounds of national security.<sup>197</sup>

The NAFTA and Canada-Chile FTA investment chapters and the NAFTA-era FIPAs have investor-state dispute settlement provisions that are more detailed. They invariably permit the aggrieved foreign investor alleging a breach of the IIA by the host state to commence international arbitration, with a choice of using the ICSID Convention, ICSID Additional Facility Rules or UNCITRAL Arbitration Rules.<sup>198</sup> However, since Canada and some of the other states in the region are not yet ICSID Convention contracting parties, the ICSID Convention rules cannot yet be used, the ICSID Additional Facility Rules can only be used if either the host state or the investor's state is a party, and the UNCITRAL Arbitration Rules are usable in all disputes.<sup>199</sup> In order to go to international arbitration, the investor has to waive its right to resort to or continue use of the domestic courts/tribunals of the host state.<sup>200</sup> The choice of law for most of this generation of IIAs uses only international law sources, typically the terms of the IIA and principles of international law.<sup>201</sup> Only the Canada-Costa Rica FIPA also includes domestic law, but only domestic law that is not inconsistent with the FIPA terms or principles of international law.<sup>202</sup> The NAFTA, Canada-Chile FTA and Canada-Venezuela FIPA also make interpretations of the IIA issued by the relevant contracting states binding on the arbitrators.<sup>203</sup>

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<sup>196</sup> In addition to permitting prudential measures in the financial sector, the FIPAs contain a limited version of GATT Article XX, a general exceptions clause permitting government measures to ensure compliance with laws not inconsistent with the FIPA, to protect human, animal or plant life or health, and to conserve exhaustible natural resources: Canada-Trinidad and Tobago FIPA, *ibid*, Arts XI, XVII(2)–(3); Canada-Barbados FIPA, *ibid*, Arts XI, XVII(2)–(3); Canada-Ecuador FIPA, *ibid*, Arts XI, XVII(2)–(3); Canada-Venezuela FIPA, *ibid*, Art X, Annex, Art II(10); Canada-Panama FIPA, *ibid*, Arts XI, XVII(2)–(3); Canada-Uruguay FIPA, *ibid*, Annex I, Art III(1)–(3); Canada-Costa Rica FIPA, *ibid*, Annex I, Art III(1)–(3). The two FTAs contain weak provisions against host state relaxation of domestic environmental, health and safety laws in order to encourage investment and permit restriction of transfers to protect balance of payments: NAFTA, *ibid*, Arts 1114, 2104; Canada-Chile FTA, *ibid*, Arts G-14, O-04.

<sup>197</sup> NAFTA, *ibid*, Arts 1138, 2102; Canada-Chile FTA, *ibid*, Arts G-39, O-02.

<sup>198</sup> NAFTA, *ibid*, Arts 1115–1122; Canada-Chile FTA, *ibid*, Arts G-16–G-23; Canada-Trinidad and Tobago FIPA, *supra* n 150, Art XIII; Canada-Barbados FIPA, *supra* n 150, Art XIII; Canada-Ecuador FIPA, *supra* n 150, Art XIII; Canada-Venezuela FIPA, *supra* n 150, Art XII; Canada-Panama FIPA, *supra* n 150, Art XIII; Canada-Uruguay FIPA, *supra* n 150, Art XII, Annex II; Canada-Costa Rica FIPA, *supra* n 150, Art XII, Annex II. National security measures and domestic review decisions on whether to allow establishment of FDI excluded from investor-state arbitration by the two FTAs and decisions concerning establishment of FDI excluded by the FIPAs.

<sup>199</sup> *Supra* n 113.

<sup>200</sup> NAFTA, *supra* n 22, Art 1121; Canada-Chile FTA, *supra* n 153 Art G-22; Canada-Trinidad and Tobago FIPA, *supra* n 150, Art XIII(3); Canada-Barbados FIPA, *supra* n 150, Art XIII(3); Canada-Ecuador FIPA, *supra* n 150, Art XIII(3); Canada-Venezuela FIPA, *supra* n 150, Art XII(3); Canada-Panama FIPA, *supra* n 150, Art XIII(3); Canada-Uruguay FIPA, *supra* n 150, Art XII(3); Canada-Costa Rica FIPA, *supra* n 150, Art XII(3) (this FIPA also prohibits international arbitration by the investor in cases where Costa Rica is a party to the dispute where a Costa Rican court has already rendered a judgment regarding the measure that is alleged to be a breach of the FIPA).

<sup>201</sup> NAFTA, *ibid*, Art 1131; Canada-Chile FTA, *ibid*, Art G-32; Canada-Trinidad and Tobago FIPA, *ibid*, Art XIII(7); Canada-Barbados FIPA, *ibid*, Art XIII(7); Canada-Ecuador FIPA, *ibid*, Art XIII(7); Canada-Venezuela FIPA, *ibid*, Art XII(7); Canada-Panama FIPA, *ibid*, Art XIII(7); Canada-Uruguay FIPA, *ibid*, Art XII(7).

<sup>202</sup> Canada-Costa Rica FIPA, *supra* n 150, Art XII(7).

<sup>203</sup> *Supra* n 201.

With this generation of IIAs, there is more detail on enforcement of investor-state arbitral awards. Such awards are binding only on the parties concerned and in respect of that case, and are enforceable (with limited exceptions) under the ICSID Convention or international arbitration laws.<sup>204</sup>

With the two FTAs, if a host state does not comply with an award against it, the investor state may request that the FTA Commission establish an arbitral panel under the inter-state dispute settlement chapter to seek a determination that such non-compliance is a breach of the FTA with recommendations for compliance.<sup>205</sup> The problem with the FTA inter-state ‘arbitral panels’ is that they are not equivalent to formally binding international arbitration since the state parties’ resolution of the dispute ‘normally shall conform with’ the report of the panel. State parties can depart from the panel’s recommendations without breaching the FTA, resulting in a possible compromissory, diplomatic settlement of the dispute.<sup>206</sup> However, if the panel finds that there is a breach of the FTA and a mutually acceptable resolution is not achieved, the complaining state can activate the trade remedy provisions of the FTA against the host state, suspending benefits of equivalent effect.<sup>207</sup>

Disputes between the contracting parties to the FIPAs over the interpretation or application of the treaty go to international arbitration.<sup>208</sup> If a host state refuses to comply with an investor-state arbitral award against it, the national state of the investor may launch inter-state arbitration against the other state, arguing that non-compliance with the award is a breach of the FIPA.<sup>209</sup> However, most of this generation of FIPAs are incoherent in their approach to the binding character of the resulting arbitral awards, partly following classical binding international arbitration (the arbitral decision ‘is/shall be binding on both’ contracting states) and partly following the NAFTA inter-state dispute settlement approach which allows the disputing states to diverge from the decision of the arbitral panel (the states’ agreed resolution of the dispute ‘shall normally implement the decision of the panel’).<sup>210</sup> In these FIPAs, if the two states cannot subsequently reach agreement, the FIPAs entitle the state in whose favour

<sup>204</sup> NAFTA, *supra* n 22, Art 1136; Canada-Chile FTA, *supra* n 153, Art G-37; Canada-Trinidad and Tobago FIPA, *supra* n 150, Art XIII(10); Canada-Barbados FIPA, *supra* n 150, Art XIII(10); Canada-Ecuador FIPA, *supra* n 150, Art XIII(10); Canada-Venezuela FIPA, *supra* n 150, Art XII(10); Canada-Panama FIPA, *supra* n 150, Art XIII(10); Canada-Uruguay FIPA, *supra* n 150, Art XII(9); Canada-Costa Rica FIPA, *supra* n 150, Art XII(10). See *supra* nn 120–1 on the ICSID Convention annulment mechanism, the New York Convention and other international arbitration law processes for setting aside or enforcing the arbitral award.

<sup>205</sup> NAFTA, *ibid*, Art 1136(5)–(6); Canada-Chile FTA, *ibid*, Art G-37(5) (investor can still launch enforcement proceedings under separate arbitration treaties).

<sup>206</sup> NAFTA, *ibid*, Art 2018(1); Canada-Chile FTA, *ibid*, Art N-17(1). Both states ‘[o]n receipt of the final report of a panel, the [disputing] Parties shall agree on the resolution of the dispute, which normally shall conform with the determinations and recommendations of the panel ...’.

<sup>207</sup> NAFTA, *ibid*, Art 2019; Canada-Chile FTA, *ibid*, Art N-18 (nullification or impairment of benefits also qualifies as actionable).

<sup>208</sup> Canada-Trinidad and Tobago FIPA, *supra* n 150, Art XV; Canada-Barbados FIPA, *supra* n 150, Art XV; Canada-Ecuador FIPA, *supra* n 150, Art XV; Canada-Venezuela FIPA, *supra* n 150, Art XIV; Canada-Panama FIPA, *supra* n 150, Art XV; Canada-Uruguay FIPA, *supra* n 150, Art XIII; Canada-Costa Rica FIPA, *supra* n 150, Art XIII.

<sup>209</sup> Canada-Trinidad and Tobago FIPA, *ibid*, Art XIII(11); Canada-Barbados FIPA, *ibid*, Art XIII(11); Canada-Ecuador FIPA, *ibid*, Art XIII(11); Canada-Venezuela FIPA, *ibid*, Art XII(11); Canada-Panama FIPA, *ibid*, Art XIII(11); Canada-Uruguay FIPA, *ibid*, Art XII(10); Canada-Costa Rica FIPA, *ibid*, Art XII(11).

<sup>210</sup> Canada-Trinidad and Tobago FIPA, *ibid*, Art XV(5), (7); Canada-Barbados FIPA, *ibid*, Art XV(5), (7); Canada-Ecuador FIPA, *ibid*, Art XV(5), (7); Canada-Panama FIPA, *ibid*, Art XV(5), (7); Canada-Uruguay FIPA, *ibid*, Art XIII(5), (7); Canada-Costa Rica FIPA, *ibid*, Art XIII(5), (7) (‘[s]uch decision shall be final and binding on both Contracting Parties’).

the arbitral decision was made to receive compensation from the other or suspend benefits of equivalent value to those awarded by the panel.<sup>211</sup> In contrast, the Canada-Venezuela FIPA uses binding international arbitration which specifies that the two states ‘shall endeavour to reach agreement ... on the manner in which to resolve their dispute in conformity with such decision’ and does not contain provisions on compensation or trade retaliation.<sup>212</sup>

Thus, in these IIAs inter-state arbitration is a fall-back protection for a foreign investor if the host state does not comply with any investor-state arbitral award. However, in a return to the early days of diplomatic protection of foreign investors, it can only be used if the national state of the investor is willing to activate this aspect of the IIA. Further, in all cases the final outcome may be a compromise and collection of monetary damages through compensation or trade retaliation may be uncertain.

Termination provisions for the FTAs provide for withdrawal of a state party from NAFTA or termination of the Canada-Chile FTA six months after a state party provides written notice to the other party or parties.<sup>213</sup> Unlike the FIPA approach, there is no provision made in either of the two FTAs for continued application of its investment chapter to investments made in the withdrawing state prior to the date of withdrawal. The FIPA termination clauses, however, state that the substantive and dispute settlement provisions of each FIPA continue in force for 15 years after termination of the FIPA with respect to covered investments or commitments to invest made prior to the date of termination.<sup>214</sup>

#### **f. 2004 Model FIPA IIAs: Peru, Colombia**

In 2004, Canada adopted a new, even more complex, Model FIPA, an adaptation of the NAFTA model based on experiences with Ch 11 and other developments in international investment law.<sup>215</sup> The 2006 Canada-Peru FIPA and the investment chapters in the Canada-Peru FTA and Canada-Colombia FTA are based on the 2004 Model FIPA, with the FTA investment chapters also influenced by NAFTA.<sup>216</sup> Chapter 8, the investment chapter of the Canada-Peru FTA, is very close in terms to the 2006 Canada-Peru FIPA. The Canada-Peru FIPA will be suspended when the Canada-Peru FTA enters into force, with one exception: the FIPA will remain in operation for fifteen years thereafter to cover any breaches of the FIPA terms occurring before the date of entry into force of the FTA.<sup>217</sup>

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<sup>211</sup> Canada-Trinidad and Tobago FIPA, *ibid*, Art XV(7); Canada-Barbados FIPA, *ibid*, Art XV(7); Canada-Ecuador FIPA, *ibid*, Art XV(7); Canada-Panama FIPA, *ibid*, Art XV(7); Canada-Uruguay FIPA, *ibid*, Art XIII(7); Canada-Costa Rica FIPA, *ibid*, Art XIII(7).

<sup>212</sup> Canada-Venezuela FIPA, *supra* n 150, Art XIV(5), (7).

<sup>213</sup> NAFTA, *supra* n 22, Art 2205; Canada-Chile FTA, *supra* n 153, Art P-05.

<sup>214</sup> Canada-Trinidad and Tobago FIPA, *supra* n 150, Art XVIII(2); Canada-Barbados FIPA, *supra* n 150, Art XVIII(2); Canada-Ecuador FIPA, *supra* n 150, Art XVIII(2); Canada-Venezuela FIPA, *supra* n 150, Art XVII(2); Canada-Panama FIPA, *supra* n 150, Art XVIII(2); Canada-Uruguay FIPA, *supra* n 150, Art XV(4); Canada-Costa Rica FIPA, *supra* n 150, Art XV(4).

<sup>215</sup> Canada 2004 Model FIPA, *supra* n 110. See Céline Lévesque, ‘Influences on the Canadian FIPA Model and the US Model BIT: NAFTA Chapter 11 and Beyond’ (2006) 44 *Canadian Yrbk Int’l L* 249; Andrew Newcombe, ‘Canada’s New Model Foreign Investment Protection Agreement’ (Fall 2004) *CCIL Bulletin* 9; Kinnear and Hansen, *supra* n 92.

<sup>216</sup> Canada-Peru FIPA, *supra* n 150; Canada-Peru FTA, *supra* n 154; Canada-Colombia FTA, *supra* n 154.

<sup>217</sup> Canada-Peru FTA, *ibid*, Art 845; Canada-Peru FIPA, *ibid*, Art 52(3).

The Canada-Peru FIPA, Canada-Peru FTA and Canada-Colombia FTA use a broad, closed-list definition of covered investment.<sup>218</sup> Many of the usual substantive provisions found in these IIAs are very similar to the terms used in the NAFTA model IIAs, although those provisions subject to a number of NAFTA Ch 11 investor-state arbitrations have been clarified or limited, typically in a manner that strengthens the position of the host state.<sup>219</sup> The minimum standard of treatment provision has now been clarified so that (1) “‘fair and equitable treatment” and “full protection and security” ... do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens”; and (2) a breach of another provision of the IIA or another treaty does not establish that the minimum standard of treatment obligation has been violated.<sup>220</sup> Also, the definition of expropriation has been clarified, covering direct or indirect nationalisation/expropriation and providing interpretative statements on the meaning of ‘indirect’ expropriation.<sup>221</sup> Investment treaty shopping has been limited in this most recent generation of agreements: the 2004 Model FIPA stipulates that the MFN treatment obligation does not apply to other treaties (for example, BITs) entered into prior to the entry into force of the FIPA or to existing or future FTAs (that is, those with investment chapters), and the Canada-Peru FIPA and FTA and the Canada-Colombia FTA add the clarification that the MFN treatment obligation ‘does not encompass dispute resolution mechanisms, such as those [in the FIPA/FTA investment chapter], that are provided for in international treaties or trade agreements’.<sup>222</sup> In the FTAs with Peru and Colombia, the chapter on financial services also covers investment in financial services, incorporating some of the substantive provisions and the dispute settlement section of the investment chapter.<sup>223</sup>

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<sup>218</sup> Canada 2004 Model FIPA, *supra* n 110, Art I; Canada-Peru FIPA, *ibid*, Art I; Canada-Peru FTA, *ibid*, Art 847; Canada-Colombia FTA, *supra* n 154, Art 838. See Newcombe, *supra* n 215 at 10; *Bilateral Investment Treaties 1995-2006*, *supra* n 91, at xi, 7–13.

<sup>219</sup> Canada 2004 Model FIPA, *ibid*, Arts 3 (national treatment), 4 (MFN treatment), 5 (minimum standard of treatment), 6–7 (prohibition of performance requirements), 9, Annexes I–III (reservations and exceptions to Arts 3, 4, 6, 7), 12 (compensation for losses), 13, Annex B.13(1) (expropriation), 14 (transfer of funds); Canada-Peru FIPA, *ibid*, Arts 3 (national treatment), 4, Annex B.4 (MFN treatment), 5 (minimum standard of treatment), 6–7 (prohibition of performance requirements), 9, Annexes I–III (exceptions to Arts 3, 4, 6, 7), 12 (compensation for losses), 13, Annex B.13(1) (expropriation), 14 (transfer of funds); Canada-Peru FTA, *ibid*, Arts 803 (national treatment), 804, Annex 804.1 (MFN treatment), 805 (minimum standard of treatment), 806–807 (prohibition of performance requirements), 808, Annexes I–II (exceptions to Arts 803, 804, 806, 807), 811 (compensation for losses), 812, Annex 812.1 (expropriation), 813 (transfer of funds), 2203 (exclusion of most tax measures); Canada-Colombia FTA, *ibid*, Arts 803 (national treatment), 804 (MFN treatment), 805 (minimum standard of treatment), 806 (compensation for losses), 807–808 (prohibition of performance requirements), 809, Annexes I–II (reservations and exceptions to Arts 803, 804, 807, 808), 810, Annex 810 (transfer of funds, capital controls), 811, Annex 811 (expropriation).

<sup>220</sup> Canada 2004 Model FIPA, *ibid*, Art 5(2)–(3); Canada-Peru FIPA, *ibid*, Art 5(2)–(3); Canada-Peru FTA, *ibid*, Art 805(2)–(3); Canada-Colombia FTA, *ibid*, Art 805(1), based on the NAFTA Free Trade Commission’s 2001 interpretation, *supra* n 188; Lévesque, *supra* n 215 at 255–63. See also the Canada-Colombia FTA, *ibid*, Art 805(2) which adds that the fair and equitable treatment obligation ‘includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process’.

<sup>221</sup> Canada 2004 Model FIPA, *ibid*, Art 13, Annex B.13(1); Canada-Peru FIPA, *ibid*, Art 13, Annex B.13(1); Canada-Peru FTA, *ibid*, Art 812, Annex 812.1; Canada-Colombia FTA, *ibid*, Art 811, Annex 811. The indirect expropriation language almost duplicates the equivalent annex in the United States 2004 model BIT which itself is based on United States jurisprudence on regulatory takings: Newcombe, *supra* n 215 at 11; Lévesque, *supra* n 215 at 284–90. The NAFTA and Canada-Chile FTA wording ‘measures tantamount to’ expropriation etc. does not appear in this generation of IIAs.

<sup>222</sup> Canada 2004 Model FIPA, *ibid*, Art 4, Annex III; Canada-Peru FIPA, *ibid*, Art 4, Annex B.4; Canada-Peru FTA, *ibid*, Art 804, Annex 804.1; Canada-Colombia FTA, *ibid*, Art 804(3).

<sup>223</sup> Canada-Peru FTA, *ibid*, Arts 1101(1)(b), 1101(2)(a)–(b), 1102–1104, 1108–1110; Canada-Colombia FTA, *ibid*, Arts 1101(1)(b), 1101(2)(a)–(b), 1102–1104, 1108–1110.

This generation of IIAs continues to exclude a variety of government measures from the treaty's ambit, including many tax measures, measures with respect to cultural industries, some measures taken to protect health, the environment and the financial system, and measures taken for national security reasons.<sup>224</sup> The FTAs with Peru and Colombia go further than prior IIAs, reflective of the increasing attention on the negative impacts of foreign, typically corporate, investment in developing countries. Each contains a clause on corporate social responsibility which states:

Each Party *should* encourage enterprises operating within its territory or subject to its jurisdiction to voluntarily incorporate internationally recognised standards of corporate social responsibility in their internal policies, such as statements of principle that have been endorsed or are supported by the Parties. These principles address issues such as labour, the environment, human rights, community relations and anti-corruption. The Parties ... remind those enterprises of the importance of incorporating such corporate social responsibility standards in their internal policies.<sup>225</sup>

While this provision is relatively soft in terms and is unenforceable,<sup>226</sup> it is groundbreaking for an IIA in its focus on the behaviour of investors. Also, like the NAFTA and Canada-Chile FTA, the FTAs with Peru and Colombia contain weak provisions indicating that the state parties *should not* weaken or eliminate domestic environmental, health and safety laws in order to encourage foreign investment.<sup>227</sup> Investment promotion also makes tentative appearances in the two FTAs; in the chapter on trade-related cooperation, the fostering of new opportunities for investment is a listed objective and investment facilitation is included as an issue that can be addressed by the Canada-Peru FTA's Committee on Investment.<sup>228</sup>

The dispute settlement provisions in this most recent generation of IIAs build on those found in the NAFTA generation IIAs. The NAFTA experience has resulted in new provisions to both heighten government control over the operation of the IIA and increase transparency of and public participation in the dispute resolution process. The 2004 Model FIPA and Canada-Peru FIPA established a commission composed of government representatives of the two states to *inter alia* supervise the implementation of the FIPA and resolve disputes over its

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<sup>224</sup> Canada 2004 Model FIPA, *supra* n 110, Arts 10, 11, 16; Canada-Peru FIPA, *supra* n 150, Arts 10, 11, 16; Canada-Peru FTA, *ibid*, Arts 1110, 2201(3), 2202, 2203, 2205; Canada-Colombia FTA, *ibid*, Arts 1110, 2201(3), (4), 2202, 2203, 2204, 2206.

<sup>225</sup> Canada-Peru FTA, *ibid*, Art 810; Canada-Colombia FTA, *ibid*, Art 816 (emphasis added). A Committee on Investment is established in each FTA to address issues such as corporate social responsibility: Canada-Peru FTA, *ibid*, Art 817; Canada-Colombia FTA, *ibid*, Art 817. Ch 19 s B in each FTA requires the two governments to adopt or maintain laws and other measures to criminalise corruption in matters affecting international trade or investment.

<sup>226</sup> In addition to its non-mandatory language, this clause is excluded from the investor-state arbitral mechanism: Canada-Peru FTA, *ibid*, Arts 819–820; Canada-Colombia FTA, *ibid*, Art 819–820.

<sup>227</sup> Canada-Peru FTA, *ibid*, Art 809; Canada-Colombia FTA, *ibid*, Art 815 (these clauses also excluded from the investor-state arbitral mechanism, consultations the only remedy). Similar to recent United States FTAs, the Canadian FTAs with Peru and Colombia contain brief chapters on labour and the environment, accompanied by side agreements on labour cooperation and the environment that aim to strengthen the content and enforcement of the two states' domestic environmental and labour rights laws. Inconsistent with the FTA investment chapters, the separate environment agreements contain stronger prohibitions against weakening, waiving or derogating from environmental laws in order to encourage investment or trade, but the only remedy is inter-state consultations. The NAFTA and Canada-Chile FTA only have separate side agreements.

<sup>228</sup> Canada-Peru FTA, *ibid*, Arts 1801(1)(c), 817(2) (committee can address investment facilitation); Canada-Colombia FTA, *ibid*, Art 1801(1)(c) (committee can address capacity-building in investment treaty matters).

interpretation or application.<sup>229</sup> The FTAs with Peru and Colombia have a Committee on Investment to act as a forum for consultation on issues related to the investment chapter, while the FTAs' Commission supervises the implementation of the treaty and makes various decisions in the investment chapter's investor-state arbitral process.<sup>230</sup>

Investor-state disputes are settled by international arbitration after the parties engage in consultations and the investor waives use of domestic tribunals, with a choice of ICSID Convention, ICSID Additional Facility Rules, UNCITRAL Arbitration Rules or other arbitral rules approved by the commission.<sup>231</sup> Although the 2004 Model FIPA does not contain a general umbrella clause, the Canada-Peru FIPA and FTA, and the Canada-Colombia FTA allow alleged breaches by the host state of a legal stability agreement (LSA, also called a juridical stability agreement or stabilisation clause) to be taken to investor-state arbitration.<sup>232</sup> LSAs are used in the investment context to enhance certainty of longer-term FDI through host state entry into an agreement with one or more investors promising that specified laws (for example, tax or administrative laws) applicable to the FDI will not be changed for a given period of time.<sup>233</sup> In this most recent generation of IIAs, the choice of law to settle the dispute is the relevant IIA and applicable rules of international law (with different choice of law rules governing disputes over LSAs), and interpretations of the IIA made by the commission are binding on the arbitral tribunal.<sup>234</sup> New provisions include those for greater transparency of the arbitral process, public access to documents and resulting awards with limited exceptions, and submissions by third party interveners as determined by the arbitral tribunal.<sup>235</sup>

As with the NAFTA-era IIAs, these agreements state that arbitral awards are binding only between the parties for that particular case and are enforceable (with limited exceptions)

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<sup>229</sup> Canada 2004 Model FIPA, *supra* n 110, Art 51; Canada-Peru FIPA, *supra* n 150, Art 50.

<sup>230</sup> Canada-Peru FTA, *supra* n 154, Arts 817, 824(2), 837–838, 2001; Canada-Colombia FTA, *supra* n 154, Arts 817, 822(2), 832, 2001 (for each FTA Joint Commission comprises the cabinet-level representatives of each state).

<sup>231</sup> Canada 2004 Model FIPA, *supra* n 110, Arts 22–27; Canada-Peru FIPA, *supra* n 150, Arts 26–27; Canada-Peru FTA, *ibid*, Arts 823–824; Canada-Colombia FTA, *ibid*, Arts 821–822 (requirement for prior consultations is stronger compared to earlier Canadian IIAs). Measures taken for national security, establishment review decisions and soft clauses on health, safety and environmental measures and corporate social responsibility excluded from dispute resolution process(es): Canada 2004 Model FIPA, *ibid*, Arts 6(3), 8(1)–(2), 19, 22–23, 47, Annex IV; Canada-Peru FIPA, *ibid*, Arts 6(3), 8(1)–(2), 10(4), 11, 19, 22–23, 51, Annex E.51; Canada-Peru FTA, *ibid*, Arts 802(4), 809, 810, 816, 819–820, 844, 2202, Annex 844.1; Canada-Colombia FTA, *ibid*, Arts 802(4), 812, 815–816, 819–820, 837, 2202, Annex 837.

<sup>232</sup> Canada-Peru FIPA, *ibid*, Arts 22(1)(b), (3), 23(1)(b), (3); Canada-Peru FTA, *ibid*, Arts 819(1)(c), (2), 820(1)(c), (2); Canada-Colombia FTA, *ibid*, Art 839 (arbitration only in accordance with Colombian law and Art 839(3)).

<sup>233</sup> Luis Carlos Rodrigo Prado, 'Fiscal Stabilization Agreements with Host Countries: What They Are and How They Work' (2005) *Proceedings of the Rocky Mountain Mineral Law 51st Annual Institute* (Rocky Mountain Mineral Law Foundation, 2005) Ch 20. On Peru's legal regime for LSAs see *Duke Energy International Peru Investments No 1 Ltd v Republic of Peru*, ICSID ARB 03/28, Award (18 August 2008), paras 37–44. The Canada-Peru FIPA, *ibid*, Art 1, defines a LSA as 'an agreement entered into by the national government of a Party and an investor of the other Party or a covered investment of such investor that accords certain benefits, including, but not limited to, a commitment to maintain the existing income tax regime during a specified time': See Canada-Peru FTA, *ibid*, Art 847; Canada-Colombia FTA, *ibid*, Art 839(4) (juridical stability contract).

<sup>234</sup> Canada 2004 Model FIPA, *supra* n 110, Art 40; Canada-Peru FIPA, *ibid*, Art 40; Canada-Peru FTA, *ibid*, Art 837; Canada-Colombia FTA, *ibid*, Arts 832, 839(3)(g) (the award also has to be consistent with commission interpretation). The choice of law rules for legal stability agreements comprise domestic law and international law.

<sup>235</sup> Canada 2004 Model FIPA, *ibid*, Arts 38–3; Canada-Peru FIPA, *ibid*, Arts 38–39; Canada-Peru FTA, *ibid*, Arts 835–836; Canada-Colombia FTA, *ibid*, Arts 830–831. See Newcombe, *supra* n 215 at 11; Lévesque, *supra* n 215 at 263–9, 291–5.

under the ICSID Convention or international arbitration laws.<sup>236</sup> The Canadian IIAs, unlike the recent United States IIAs, do not provide for the possibility of an appellate body to review arbitral awards.<sup>237</sup> Under the FIPAs, if the state does not comply with an arbitral award, an arbitral panel under the inter-state arbitral mechanism is constituted if the investor state requests its establishment. If this panel finds that noncompliance is inconsistent with the FIPA, it can provide recommendations that the state comply with the award, and the two states are to agree on a settlement of the dispute that ‘shall normally implement the decision of the panel’, with compensation or trade remedies due to the investor’s state if an agreement is not reached.<sup>238</sup> Similarly, in the FTAs with Peru and Colombia, if there is host state noncompliance with the award, the investor state may request that the FTA Commission establish an arbitral panel under the inter-state dispute settlement chapter to seek both a determination that noncompliance breaches the FTA and recommendations for compliance.<sup>239</sup> As with the earlier FTAs, the state parties’ resolution of the dispute does not have to be in accordance with the terms of the panel report.<sup>240</sup> If the panel determines that there is a breach of the FTA and an inter-state resolution is not obtained or complied with, the complaining state can impose trade remedies on the other.<sup>241</sup>

The Canada-Colombia FTA follows the NAFTA and Canada-Chile FTA approach to termination, stating that the treaty can be terminated after six-months’ notice, with no provision for an extended life for the investment chapter.<sup>242</sup> However, the Canada-Peru FTA investment chapter has an extended termination date. It states that the Canada-Peru FTA will remain in force for 15 years after termination of the FTA for the purposes of any breach of the obligations of the investment chapter (and a few articles in the competition chapter) that occurred prior to the termination of the FTA and, during this period, the rights of an investor to make an arbitral claim against a host state shall be governed by the relevant provisions of the FTA.<sup>243</sup> The FIPA termination clauses are consistent with the earlier FIPAs, providing that the substantive and dispute settlement provisions of each FIPA continue in force for 15 years after termination of the FIPA with respect to covered investments or commitments to invest made prior to the date of termination.<sup>244</sup> The FIPAs are still more generous as they cover host state breaches of the FIPA that occur after the termination of the FIPA within a 15-year period.

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<sup>236</sup> Canada 2004 Model FIPA, *ibid*, Art 45; Canada-Peru FIPA, *ibid*, Art 45; Canada-Peru FTA, *ibid*, Art 842; Canada-Colombia FTA, *ibid*, Art 835. See *supra* nn 120–1.

<sup>237</sup> For example, US 2004 Model BIT, *supra* n 110, Annex D; Lévesque, *supra* n 215 at 277–84.

<sup>238</sup> Canada 2004 Model FIPA, *supra* n 110, Arts 45(5), 48(7), (9); Canada-Peru FIPA, *supra* n 150, Arts 45(5), 47(7), (9) (the investor’s state must request such a panel). See the slightly different approach in the NAFTA-era FIPAs, *supra* text accompanying nn 209–11.

<sup>239</sup> Canada-Peru FTA, *supra* n 154, Art 842(5); Canada-Colombia FTA, *supra* n 154, Art 835(5).

<sup>240</sup> Canada-Peru FTA, *ibid*, Art 2113(1); Canada-Colombia FTA, *ibid*, Art 2113(1), but language is different from the NAFTA and Canada-Chile FTA, *supra* n 205.

<sup>241</sup> Canada-Peru FTA, *ibid*, Arts 2113(3), 2114; Canada-Colombia FTA, *ibid*, Arts 2113(3), 2114.

<sup>242</sup> Canada-Colombia FTA, *ibid*, Art 2305, *supra* text accompanying n 213.

<sup>243</sup> Canada-Peru FTA, *supra* n 154, Art 846 (this operates notwithstanding the six-month-notice provision for termination of the FTA in Art 2305; the financial services chapter obligations are not included).

<sup>244</sup> Canada 2004 Model FIPA, *supra* n 110, Art 52(3); Canada-Peru FIPA, *supra* n 150, Art 52(3).

### **g. Comparative Aspects**

Most of Canada's IIAs with Latin American and Caribbean states, comprising FIPAs and a growing number of FTA investment chapters, are of recent origin, based on the NAFTA and 2004 IIA models. Only the Canada-Argentina FIPA is based on the oldest model.

While there are some differences between the terms of these Canadian IIAs, for the most part they provide good legal protections for Canadian investors. Even the earlier Canada-Argentina FIPA has its comparative advantages. While it does not contain a right of establishment of investment, and does not prohibit the host state from imposing performance requirements, host state obligations are cast in more general terms without the qualifications and exceptions found in later IIAs: it does not exclude tax measures or cultural industries from treaty protection and there is no national security clause that permits host government action that can detrimentally affect foreign investment.

In some respects, the NAFTA generation of IIAs entered into by Canada (with Mexico, Chile, Trinidad and Tobago, Barbados, Ecuador, Venezuela, Panama, Uruguay and Costa Rica) have a more liberal attitude to FDI protection. This can be seen in their qualified right of establishment (although the FIPA with Venezuela is more restrictive), the variety of core host state obligations and the prohibition of performance requirements (although both Venezuela and Uruguay have negotiated more limited obligations). However, one can see the development of greater freedom for host government regulation in this generation of IIAs; for example, in the exclusion of many tax measures and the expansion of allowable host government measures taken in various sectors. However, only the NAFTA and Canada-Chile FTA contain national security clauses. Recent Canadian IIAs that follow 2004 Model and NAFTA experience (Canada-Peru FIPA and FTA, and Canada-Colombia FTA) enshrine even greater host state freedom of action through clarifications of substantive provisions and the limitation or exclusion of a range of government conduct from treaty protection, including for national security reasons.

Investor-state dispute settlement provisions predominantly permit the investor to unilaterally launch international arbitration against the host state, although it is increasingly doubtful that the Canada-Argentina FIPA provisions on first resort to the domestic courts can be avoided via the MFN clause. If there are problems encountered by an investor in enforcing an arbitral award against a host state that cannot be resolved through the applicable international and domestic law on enforcement of awards, the Canadian IIAs provide differing levels of detail on inter-state procedures to enforce the award. While the Canada-Argentina FIPA has little detail in this regard, the later FIPAs and FTA investment chapters give the investor state the discretion whether or not to start international arbitration against the host state. If international arbitration results in an award in favour of the investor state, most of the IIAs (except the Canada-Venezuela FIPA) specify that trade retaliation can be taken if the host state does not comply. While these IIA provisions are almost forgotten elements, they may become more relevant if some Latin American countries become more resistant to honouring their IIA commitments.

Termination provisions in all Canadian FIPAs are more generous than most of the FTA investment chapters. FIPA provisions remain in force for 15 years after the termination of the relationship for investments and commitments to invest made prior to that date, whereas the termination of most of the FTAs ends their investment chapter rights and obligations. Only the Canada-Peru FTA follows substantially the FIPA approach. The volatile political changes in some Latin American states also render the differences in these clauses relevant.

**xliii. Canada's FIPAs and FTA Investment Chapters with Latin American and Caribbean States: Current Uncertainties, Host State Tendencies**

**IAs with Latin American and Caribbean States: Investor-State Arbitral Awards**

A phenomenon of the past decade is the rapid increase in the number of arbitral awards interpreting IIA provisions that have been issued under ICSID and other international arbitral processes. UNCTAD reports that the cumulative number of known investor-state awards issued by the end of 2007 was 288, with 95 of these cases involving FDI in infrastructure.<sup>245</sup> In particular, investor-state arbitrations have been brought regularly under NAFTA Ch 11, and many of them have provided interpretations of the national treatment, minimum standard of treatment and expropriation provisions.<sup>246</sup> This has brought positive developments to international investment law, including a growing corpus of awards interpreting IIA provisions that, while not binding on other arbitral tribunals, provide persuasive guidance for arbitrators. These arbitral awards will be influential for arbitrators who have to interpret similar provisions found in IIAs that Canada has entered into. However, there have been other, sometimes negative, developments, including the problem of inconsistent arbitral awards where tribunals in different arbitrations reach different results where the facts of the cases and the IIA terms are very similar or identical and the use of 'forum shopping' whereby a corporate investor changes its place of incorporation in order to gain better protection from another state's IIA.<sup>247</sup>

A discussion of the large number of investment treaty awards, including NAFTA Ch 11 awards, is beyond the scope of this paper. However, there have been very few investor-state arbitral awards to date between Canadian investors and host states in Latin America and the Caribbean. The few that have been issued illustrate to a certain degree the uncertainties of application and interpretation of IIAs by arbitral tribunals.

There has been only one NAFTA Ch 11 arbitral award involving a Canadian investor in Mexico, in *International Thunderbird Gaming Corp v United Mexican States*.<sup>248</sup> This case involved a poor fact scenario: Mexico prohibited gambling and the Canadian investor, in trying to obtain a Mexican Government opinion on the legality of gaming machines that it wanted to operate in Mexico that in fact involved chance, represented to the government that the games were based on skill. The Mexican Government's opinion indicated that it could not prohibit machines based on skill, but there could be no luck or gambling involved. After the

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<sup>245</sup> UNCTAD *World Investment Report 2008*, *supra* n 62, at xxiv, 16, 164 (infrastructure FDI comprises electricity, transportation, water, sanitation, telecommunications).

<sup>246</sup> For NAFTA Ch 11 arbitrations see NAFTA Claims: <<http://www.naftaclaims.com>>.

<sup>247</sup> See, for example, Van Harten, *supra* n 73 at 6–8, 113–17, 120, Ch 7; Franck, 'The Legitimacy Crisis', *supra* n 91.

<sup>248</sup> *International Thunderbird Gaming Corp v United Mexican States*, Final Award (26 January 2006), NAFTA Claims: <<http://www.naftaclaims.com>>, 'Disputes' — 'Mexico'. A Mexican pharmaceutical company investor brought a claim against Canada in 1996 but it withdrew its Notice of Intent without proceeding further: *Signa SA de CV v Canada*, <<http://www.international.gc.ca/trade-agreements-accords-commerciaux/disp-diff/nafta.aspx?lang=eng>>.

Mexican Government subsequently closed the investor's gaming facilities, the investor claimed violations of NAFTA Ch 11, but was unsuccessful on all counts.<sup>249</sup>

The NAFTA Ch 11 award on jurisdiction in *The Canadian Cattlemen for Fair Trade v USA* is important for its general discussion of the subtle differences between a BIT/FIPA and an investment chapter nested inside a larger FTA; that is, NAFTA Ch 11.<sup>250</sup> The award considered that the NAFTA investment chapter 'is a much more complex instrument than a simple bilateral investment treaty'.<sup>251</sup> The tribunal opined that although many of the provisions in Ch 11 are typical of BITs, the investment chapter is multilateral and operates as part of a larger treaty that sometimes requires an analysis of the interrelationship of different sections of the FTA, with the result that it must be considered in its larger context.<sup>252</sup> Although most FTAs that Canada has entered into, or is negotiating with countries in the region, are bilateral (excepting CARICOM and CA4 negotiations), *The Canadian Cattlemen for Fair Trade* NAFTA award indicates how, regardless of the number of state parties, an FTA investment chapter may need to be interpreted in light of clauses in other chapters of the FTA, which may result in a slightly different approach to FTA investment chapter interpretation compared to FIPA interpretation.

To date there are few investor-state arbitrations based on Canadian FIPAs. A number of FIPA arbitrations involving Canadian investors in Latin America are ongoing.<sup>253</sup> For example, in *Vannessa Ventures Ltd v Bolivarian Republic of Venezuela*, based on the Canada-Venezuela FIPA, a Canadian company claimed its rights to a gold and copper mining concession were expropriated by the Venezuelan Government. The ICSID arbitral tribunal has recently dismissed jurisdictional objections to most of the claims.<sup>254</sup> Venezuela had not recognised the transfer of shares in the investment from a prior Canadian investor to the claimant and argued that the FIPA's establishment clause was operative, excluding decisions by the host state not to permit establishment of investment in the country from the investor-state arbitral mechanism.<sup>255</sup> In rejecting this argument, the tribunal decided that a ruling or order by the

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<sup>249</sup> *Ibid.* The arbitral tribunal held that the government opinion did not generate a legitimate expectation upon which the investor could reasonably rely to the effect of bringing its claims under NAFTA Arts 1102, 1105 or 1110 (paras 148, 166); Art 1102 (national treatment) was not violated because there was no evidence that the investment was treated, in like circumstances, worse than those of Mexican nationals, and Art 1102 could not be relied on to justify equality of non-enforcement concerning an activity that is illicit in the host state (paras 178–183); Art 1105 (minimum standard of treatment) was not violated based on various reasons including the holding that the investor could not reasonably rely on the government opinion to its detriment as discussed above (paras 195–201); Art 1110 (expropriation) was not violated because the investor could not have operated in Mexico based on a legitimate expectation so compensation was not owed for a regulatory taking where the investor/investment did not enjoy a vested right in the business activity subsequently prohibited (para 208). See investor's unsuccessful attempt to have award set aside: *International Thunderbird Gaming Corp v United Mexican States*, 473 F Supp 2d 80 (DDC 2007).

<sup>250</sup> *The Canadian Cattlemen for Fair Trade v USA*, NAFTA Ch 11, Award on Jurisdiction (28 January 2008). The tribunal held that they did not have jurisdiction to hear the merits of the claim brought by Canadian cattlemen hit by United States import bans on Canadian beef.

<sup>251</sup> *Ibid.*, paras 114, 169. But see para 168.

<sup>252</sup> *Ibid.*, paras 164–166.

<sup>253</sup> For example, *Vannessa Ventures Ltd v Bolivarian Republic of Venezuela*, ICSID Case No ARB(AF)/04/6, Decision on Jurisdiction (22 August 2008) (*Vannessa Ventures*); *Alasdair Ross Anderson and Others v Republic of Costa Rica*, ICSID Case No ARB(AF)/07/3 (government closure of investment firm after it was allegedly used for money laundering); *Quadrant Pacific Growth Fund LP and Canasco Holdings Inc v Republic of Costa Rica*, ICSID Case No ARB(AF)/08/1 (agricultural investment).

<sup>254</sup> *Vannessa Ventures*, *ibid*

<sup>255</sup> *Ibid.*, paras 3.2.1–3.2.4; Canada-Venezuela FIPA, *supra* n 150, Annex, Art II(3)(b).

Venezuelan Government would be necessary to constitute such a decision, and the facts disclosed that there had been no such ruling.<sup>256</sup> The tribunal also found that the claimant had waived its rights to continue proceedings in the Venezuelan courts and the claim relating to the copper concessions was not time barred.<sup>257</sup> The issue whether the claimant properly acquired rights to the concessions under Venezuelan law was deferred to the merits stage of the proceedings.<sup>258</sup>

BIT tax exclusion provisions were at issue in both the 2004 award in *Occidental Exploration and Production Company v Republic of Ecuador* (based on the United States-Ecuador BIT)<sup>259</sup> and the 2006 award in *EnCana Corporation v Republic of Ecuador* (based on the Canada-Ecuador FIPA).<sup>260</sup> Both cases concerned the changes to Ecuador's tax law that stopped refunds of value-added sales tax (VAT) payments made to the companies. Both companies had investment contracts with the government, however in *EnCana* the contract was entered into by wholly-owned subsidiaries of EnCana. Ecuador took the position in both cases that the refunds were included in a formula in the investment contract that gave the company a share of the oil obtained from its Ecuador project. Despite similar facts in the two claims, there were also slight differences in the wording of each BIT. The two tribunals reached different conclusions: in *Occidental*, the tribunal decided in favour of the investor, whereas in *EnCana* the Canadian company was unsuccessful in its claim.

In the *Occidental* case, the tribunal stated that the contract was 'central to the dispute'. It took jurisdiction by characterising the impugned government conduct as a measure that was not excluded from BIT protection by the treaty's tax clause because it involved a tax matter 'with respect to ... the observance and enforcement of terms of an investment agreement ...'.<sup>261</sup> As a result, the tribunal proceeded to examine whether Ecuador had breached various substantive provisions in the BIT. It decided that the national treatment and fair and equitable treatment obligations had been violated and the guarantee against arbitrariness had been partially breached; however, it was held that there was no direct or indirect expropriation of the investment.<sup>262</sup> The tribunal awarded Occidental US\$75 million, although Ecuador tried unsuccessfully for a number of years to have the award overturned in the English courts.<sup>263</sup>

In the *EnCana* arbitration, a more detailed Art XII(1) of the Canada-Ecuador FIPA stated that 'nothing in this [FIPA] shall apply to taxation measures' except as listed in Art XII, with the

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<sup>256</sup> *Ibid*, para 3.2.4.

<sup>257</sup> *Ibid*, paras 3.4.1–3.5.4.

<sup>258</sup> *Ibid*, paras 3.3.1–3.3.4.

<sup>259</sup> *Occidental Exploration and Production Company v Republic of Ecuador* (Merits), LCIA Case No UN 3467 (1 July 2004), 17(1) *World Trade & Arb Mat* 165: <<http://www.ita.law.uvic.ca>> (*Occidental*); Susan D Franck, 'Occidental Exploration & Production Co v Republic of Ecuador' (2005) 99 *AJIL* 675. See second (ICSID) arbitral claim brought by Occidental against Ecuador in 2006 after the government terminated Occidental's oil exploration contract: *Occidental Petroleum Corporation, Occidental Exploration and Production Company v Republic of Ecuador*, ICSID Case No ARB/06/11, Decision on Jurisdiction (9 September 2008).

<sup>260</sup> *EnCana Corporation v Republic of Ecuador*, LCIA Case No UN3481, UNCITRAL, Final Award (3 February 2006), (2006) 45 *ILM* 895 (*EnCana*).

<sup>261</sup> *Occidental*, *supra* n 259, paras 64–77 (US-Ecuador BIT Art X(2)(c)).

<sup>262</sup> *Ibid* paras 78–92, 156–92 (expropriation claim was considered as an admissibility issue).

<sup>263</sup> Ecuador litigated in the English courts (legal *situs* of the arbitration), arguing that the tribunal had exceeded its jurisdiction in allowing a tax claim to be arbitrated under the BIT, culminating in *The Republic of Ecuador v Occidental Exploration and Production Company* [2007] EWCA Civ 656 (CA), dismissing appeal from [2006] 1 Lloyd's Rep 773 (HCJ): <<http://www.ita.law.uvic.ca>>. In 2006, EnCana sold its Ecuador investment and decided not to challenge its award: *Foreign Investment in Latin America and the Caribbean 2006*, *supra* n 26 at 37.

list including both a claim that a tax measure breaches an agreement between the host government and the investor concerning an investment (Art XII(3)) and a claim that a tax measure has resulted in expropriation of the investment (Art XII(4)), unless, in both cases, the two state parties have determined that there is no breach or expropriation.<sup>264</sup> The tribunal found that the VAT tax issue constituted a tax measure but held that it did not have jurisdiction to hear the claim under Art XII(3). The tribunal's reasons were, first, the argument had not been made that the investment contract had been breached and, second, the contract had been entered into by EnCana's subsidiaries so it did not constitute an Art XII(3) agreement, since the subsidiaries did not fall within the FIPA's definition of 'investor'.<sup>265</sup> Consequently, arguments that Ecuador had violated the national treatment, fair and equitable treatment and encouragement of favourable investment conditions obligations could not be addressed on the merits. The tribunal did hold that EnCana's claim that the tax measure was expropriatory could be examined on the merits pursuant to Arts XII(4) and VIII.<sup>266</sup> However, a majority of the tribunal decided that there was no indirect or direct expropriation of EnCana's investment in Ecuador.<sup>267</sup>

While the differences both in the structures of the investments and the terms of the two BITs in the *Occidental* and *EnCana* cases make it difficult to argue that this is a situation of inconsistent awards, the two arbitrations do illustrate how minor variations in the facts and/or BIT wording can lead different tribunals to opposite results for investors with different home states.<sup>268</sup> The *Occidental* case also highlights how host states can try to avoid or delay the payment of damages awarded to foreign investors by contesting the award in domestic legal systems, although this is an accepted part of international arbitration (and investors also try to have unfavourable awards set aside). While the philosophy underlying modern international arbitration law emphasises party autonomy and support for the international arbitral process, even ultimately unsuccessful litigation can result in substantial delays in enforcement of the award.

Argentina has stayed within the international arbitration framework to date by using various methods to try to manage the large number of investor arbitral claims brought against it.<sup>269</sup> Further, the recent ICSID arbitral award in *Continental Casualty Company v Argentine Republic* is a welcome development for Argentina in the context of those claims applying the

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<sup>264</sup> Canada-Ecuador FIPA, *supra* n 150, Art XII.

<sup>265</sup> *EnCana*, *supra* n 260, paras 107, 109, 133–168.

<sup>266</sup> *Ibid*, paras 109, 168 (because the two governments had not determined that there was no expropriation based on Art XII(4)).

<sup>267</sup> *Ibid*, paras 169–200; Canada-Ecuador FIPA, *supra* text accompanying n 150. On indirect expropriation, the tribunal stated at para 177: 'Only if a tax law is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised. In the present case ... the denial of VAT refunds in the amount of 10% of transactions associated with oil production and export did not deny EnCana "in whole or significant part" the benefits of its investment.' On the direct expropriation claim, the tribunal found that although the EnCana subsidiaries had a right to the VAT refunds under domestic law for the period before the law was amended, that right was not expropriated because there was no actual and effective repudiation of the legal rights because there were available remedies in the domestic courts, *inter alia* the companies could and did take advantage of domestic court proceedings, when the tax authorities lost cases it complied with the court decisions and the decisions were not partisan, biased or non-independent: *ibid*, paras 179–199.

<sup>268</sup> See, for example, Luke Eric Peterson, *Analysis: Ecuador and its Tax Arbitration with Occidental and Encana* (14 March 2006), on-line: International Institute for Sustainable Development, *Investment Treaty News*.

<sup>269</sup> See *supra* text accompanying nn 135–6.

United States-Argentina BIT.<sup>270</sup> Article XI of the BIT enables the host state to take measures necessary for ‘the maintenance of public order’ or ‘the protection of its own essential security interests’. This national security-like clause has been relied on by Argentina as a defence for the FDI-impacting measures it took during its economic crisis. Some earlier awards against Argentina had rejected a government defence based on Art XI and customary norms.<sup>271</sup> In contrast, the *Continental Casualty* award found that Argentina could take advantage of the Art XI defence if its terms were satisfied, with the result that Art XI then ‘restricts or derogates from the substantial obligations undertaken’ by the BIT parties.<sup>272</sup> The tribunal found that the Argentine economic crisis and the measures taken by the government to combat that crisis fell within Art XI, and that the measures were mostly ‘necessary’ as required by Art XI.<sup>273</sup> Most of the investor’s substantive claims were rejected by operation of the Art XI defence, the others failed on the merits and the government was ordered to pay only US\$2.8 million.<sup>274</sup> If the *Continental Casualty* award is influential in pending arbitrations involving United States investor claims against Argentina arising out of the economic crisis, Argentina can likely anticipate further success from the use of this defence.

Recent empirical research by Susan Franck on investor-state awards made public up to May 2006 deflates certain misconceptions about investor-state arbitrations.<sup>275</sup> While the number of IIA arbitrations has increased and most investor claimants come from industrialised states, respondents in investor-state arbitrations are states at all levels of development. Middle-income states form the largest component, with only Argentina and Mexico experiencing a relatively larger number of claims brought against them (although the number of Latin American state respondents in ICSID claims has increased recently).<sup>276</sup> Also, investors clearly do not always meet with success after pursuing their claims — of the claims that resulted in final awards, the investor was successful and received damages in 38.5% of the cases. Their claims failed and the host government had no financial liability in 57.7% of the

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<sup>270</sup> *Continental Casualty Company v Argentine Republic*, ICSID Case No ARB/03/9 (Award, 5 September 2008) (*Continental Casualty*). The company has lodged an ICSID annulment application. See also *LG&E Energy Corp v Argentine Republic*, ICSID case No ARB/02/1 (Award, 3 October 2006), paras 201–261 (United States-Argentina BIT, violation of fair and equitable treatment obligation violated but Argentina excused from liability for short period during crisis on basis of necessity).

<sup>271</sup> For example, *CMS Gas Transmission Company v Argentine Republic (CMS)*, ICSID Case No ARB/01/8, (Award, 12 May 2005), annulment decision (25 September 2007) (2007) 46 *ILM* 1132 (US\$133 million award against Argentina, annulment committee rejected most claims of Argentina that award should be annulled but critical of numerous errors of law in award); Jürgen T Kurtz, ‘ICSID Annulment Committee Rules on the Relationship Between Customary and Treaty Exceptions on Necessity in Situations of Financial Crisis’ (20 December 2007) *ASIL Insight* n 7.

<sup>272</sup> *Continental Casualty*, *supra* n 270, para 164 (tribunal accepted position of the *CMS* annulment committee, and did not directly apply the customary international law necessity defence).

<sup>273</sup> *Ibid*, paras 169–222 (the tribunal also found that Art XI is not self-judging).

<sup>274</sup> *Ibid*, paras 221–222, 237–303 (government’s restructuring of treasury Bills occurred in 2004 after crisis had passed so that it was not necessary within the terms of Art XI and breached the fair and equitable treatment BIT obligation).

<sup>275</sup> Susan D Franck, ‘Empirically Evaluating Claims About Investment Treaty Arbitration’ (2007) 86 *North Carolina L Rev* 1.

<sup>276</sup> *Ibid* at 26–33, 44–7. See also *UNCTAD World Investment Report 2008*, *supra* n 62 at 16 (of the 73 known investor-state arbitrations at 2007 year end, the respondents comprised 45 developing states, 16 developed states and 12 South East Europe/CIS states, with Argentina and Mexico continuing to be subjected to the largest number of claims).

cases and the remainder resulted in settlement agreements.<sup>277</sup> In addition, Franck's research found that tribunals awarded damages in less than 50% of cases and investors did not win overly large amounts of damages in those arbitral claims that were successful.<sup>278</sup> Similarly, UNCTAD's research on infrastructure investor-state arbitrations concluded with final awards by the end of 2007 found that although the investors claimed a total of US\$6.16 billion in damages, tribunals awarded only a total of US\$649.3 million in damages.<sup>279</sup>

#### h. IIA Host State Tendencies

Despite the evidence that investors are not overly favoured in investment treaty arbitrations, some IIA state parties have begun to circumscribe the application and interpretation of substantive obligations and dispute settlement provisions in IIAs. As discussed earlier, this tendency is already pronounced in the behaviour of the NAFTA states where industrialised states have been placed in the host-state position in investor-state arbitrations.<sup>280</sup> Globally, the renegotiation of older BITs is ongoing. Replacement IIAs increasingly reset the balance between investor rights and the host state, giving a more expansive role to the host state to regulate in the public interest.<sup>281</sup> Other suggestions are being made to reset this balance, including an 'arbitration-avoidance strategy' that increases the use of non-adjudicative forms of dispute resolution, such as conciliation or mediation, to settle investor-state disputes.<sup>282</sup> However, as discussed earlier, a more reactionary attitude can be seen on the part of a few nationalist Latin American states. Ecuador and Venezuela are terminating or renegotiating some of their BITs, and Ecuador and Bolivia have terminated or limited their ICSID Convention relationships.<sup>283</sup> Yet these appear to be isolated moves, and most other states in Latin America and the Caribbean remain open to FDI.<sup>284</sup>

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<sup>277</sup> Franck, *ibid* at 48–52. Also, while investors were more likely to be successful than not at the stage determining whether the tribunal had jurisdiction to hear the merits of the claim, host governments were more successful at the merits phase: *ibid* at 52–4. See also *UNCTAD World Investment Report 2008*, *ibid* at 17 (133 of the 288 cumulative cases ended by 2007 year end, with 41 decided in favour of the state, 39 in favour of the investor, 42 settled amicably, 11 not made public and 155 still pending).

<sup>278</sup> Franck, *ibid* at 55–65 (out of 52 cases where damages were awarded, in 31 cases investors were awarded nothing and in 21 cases damages were awarded with the average award being US\$25.58 million).

<sup>279</sup> *UNCTAD World Investment Report 2008*, *supra* n 62 at 166 (in some awards the government prevailed and no damages were awarded; the \$649.3 million amounted to just over 10% of total damages claimed or 25% of the damages claimed in the nine cases where damages were awarded).

<sup>280</sup> For example, NAFTA Commission interpretation binding on arbitral tribunals limiting the meaning of Art 1105 (minimum standard of treatment), NAFTA Free Trade Commission, *Notes of Interpretation of Certain Chapter 11 Provisions*, *supra* n 188; United States and Canada 2004 Model BITs limit interpretation of minimum standard of treatment and indirect expropriation obligations, make government interpretations of the IIA binding on its investor-state arbitral tribunals: *supra* text accompanying nn 110, 234; 2006 Canada-US Softwood Lumber Agreement (SLA) suspends operation of NAFTA Ch 11 investor-state arbitral mechanism for Canadian and United States investors with respect to matters arising under or in connection with the implementation of the SLA, between the Government of Canada and the Government of the United States of America (as in force 12 October 2006): Art XI(2), <<http://www.international.gc.ca/trade/eicb/softwood/SLA-main-en.asp>>; United States-Australia FTA investment chapter does not include an investor-state arbitral dispute settlement mechanism: US-Australia Free Trade Agreement Art 11.16: <[http://www.ustr.gov/assets/Trade\\_Agreements/Bilateral/Australia\\_FTA/Final\\_Text/asset\\_upload\\_file148\\_5168.pdf](http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Australia_FTA/Final_Text/asset_upload_file148_5168.pdf)>.

<sup>281</sup> *UNCTAD World Investment Report 2008*, *supra* n 62 at 15.

<sup>282</sup> *Ibid* at 17, 169; Susan D Franck, 'Integrating Investment Treaty Conflict and Dispute Systems Design' (2007) 92 *Minnesota L Rev* 161.

<sup>283</sup> *Supra* text accompanying nn 137–41.

<sup>284</sup> *UNCTAD World Investment Report 2008*, *supra* n 62 at xvi–xvii, 12–13.

Extreme reactions of this kind may be based on policies of economic nationalism. According to Amy Chua, they may also be due to politically empowered but poor indigenous majorities in these Andean countries reacting against market-dominant ethnic minorities and their foreign investor allies (with ethnicity broadly defined as 'whiteness'/European heritage), through nationalisations and other targeting of wealth.<sup>285</sup> From another perspective, Yackee argues that the ideational foundation supporting the interest of developing states in BITs may change if growing numbers of these states develop new subjective beliefs that the costs of these treaties are greater than the benefits they confer.<sup>286</sup>

A related concern is whether a growing number of arbitral awards decided against Latin American states involving large amounts of monetary damages will lead these nations to reject their IIA commitments. As noted, Argentina in particular, but also Ecuador, Venezuela and Mexico, still face numerous ICSID claims. Ironically, as Vandeveldel notes:

The same large arbitral awards in favor of investors that may convince investors of the value of the agreements, of course, may also cause host states to conclude that the agreements are too costly. This could be true to the extent that international investment agreements over time are not perceived as attracting increased investment flows. Developing countries may come to see the agreements as poor bargains in which states surrender portions of their sovereignty and subject themselves to costly arbitrations with investors, without having gained appreciable new investments as a result.<sup>287</sup>

While this is a possibility with respect to a few Latin American states, it is unlikely that the other states following liberal economic FDI policies in the region will terminate their IIA commitments. Also, as Vandeveldel recognises, foreign investors who are comforted by the fact that an IIA has been the foundation for arbitral awards in their favour may increase investment into the host state, thus providing the host with financial benefits for continuing with its IIA commitments.<sup>288</sup> Further, since many states in Latin America and the Caribbean have entered into IIAs, a state that withdraws from its IIA commitments in conjunction with a hostile attitude to FDI may expect to lose new FDI which may be diverted to other states in the region that have more liberal and stable investment climates.<sup>289</sup> The possibility of receiving diverted FDI may be an incentive for some states to maintain their IIAs and for others to think twice about terminating theirs. Another question is whether an FTA investment chapter will be more difficult to terminate compared to a BIT, since a larger trade relationship would also be jeopardised. However, the relative novelty of FTA investment chapters in the region and the need for empirical research makes these questions difficult to answer at present.

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<sup>285</sup> Amy Chua, *World on Fire* (2003) Ch 2.

<sup>286</sup> Jason Webb Yackee, 'Are BITs Such a Bright Idea? Exploring the Ideational Basis of Investment Treaty Enthusiasm' (2005–06) 12 *UC Davis J Int'l L & Pol'y* 195.

<sup>287</sup> Vandeveldel, *supra* n 71 at 186.

<sup>288</sup> *Ibid* at 189.

<sup>289</sup> *Supra* text accompanying n 88; See generally, Vandeveldel, *supra* n 71 at 190; Glen Biglaiser and Karl DeRouen, Jr, 'Economic Reforms and Inflows of Foreign Direct Investment in Latin America' (2006) 41:1 *Latin American Research Review* 51 (while not addressing BITs, authors argue that attempts to minimise expropriation risk and domestic finance/trade reform attract FDI into Latin American states).

i. **Consequences for Canadian IIAs: Current Uncertainties, Host State Tendencies**

Overall, the empirical evidence on the actual experiences of investors in investment treaty arbitrations and the movement of IIA states to limit the reach of IIAs leads to the argument that, in practice, IIAs (both BITs and FTA investment chapters) may not always provide for the level of foreign investor legal protection that may have been anticipated by the investor state when these treaties were initially drafted.<sup>290</sup>

Accordingly, Canadian IIAs with Latin American and Caribbean states may not always provide fully comprehensive legal protection when these agreements are tested in practice. If a dispute passes the jurisdictional hurdles, clear cases of direct expropriation or discrimination against Canadian investors *vis-à-vis* their domestic or third state counterparts are much more likely to be successful on the merits. However, in a number of disputes governmental conduct is directed at achieving legitimate public policy objectives and is more ambiguous in terms of impact. The variable facts of these cases, the general language in some IIA clauses, the growing number of qualifications and exclusions that broaden the scope of permissible host conduct, and the variable interpretation of IIA provisions by different arbitral tribunals operating without both appellate oversight and the requirement to follow earlier awards results in uncertain outcomes for some disputes involving Canadian IIA application and interpretation. Political and legal developments in a few Latin American states also provide uncertainty concerning the contents and future of Canadian IIAs with Ecuador and Venezuela.

## 24. Conclusion

Canadian FDI has moved into Latin America and the Caribbean since the late nineteenth century and there has been a resurgence of flows into the region over the past two decades. Countries in Latin America and the Caribbean have exhibited fluctuating attitudes to foreign investment. While the current climate in the region is predominantly welcoming for foreign investment in general and Canadian OFDI in particular, a few Latin American countries — notably Venezuela, Bolivia and Ecuador — have adopted economic nationalist policies, particularly impacting natural resources and infrastructure foreign investors. These states are restricting foreign investment in a growing number of sectors and renegotiating or withdrawing from international law commitments to protect foreign investment.

Over the past 50 years, international investment law has evolved mainly into a patchwork of bilateral and sub-regional IIAs which protect foreign investors by placing legal obligations on host states with respect to treatment of the foreign investment/investor, and permitting aggrieved foreign investors to take host states to binding international arbitration to enforce the treaty obligations. This development is seen in Latin America and the Caribbean where Canada has participated in the investment treaty project and entered into a growing number of bilateral investment treaties (FIPAs) and FTA investment chapters. While the actual number of Canada's IIAs with countries and territories in the region is relatively modest, Canada does have IIAs with many of the states which receive large amounts of Canadian OFDI. If Canada's current FTA negotiations with states in the region are successful, Canada will increase its IIA protection markedly.

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<sup>290</sup> UNCTAD *World Investment Report 2008*, *supra* n 62 at xxv, 168 (based on UNCTAD empirical research discussed in *supra* nn 276–9).

Most of Canada's IIAs with Latin American and Caribbean states have been adopted in the past 15 years and thus are predominantly based on more modern and complex NAFTA and 2004 IIA models. Only the Canada-Argentina IIA is based on an older model. While there are some differences between the terms of these Canadian IIAs, for the most part they provide good protection for Canadian investors in legal terms. However, the most recent IIAs, based on the 2004 model and NAFTA experience, provide for slightly more host state freedom of action. Canada has begun to focus more on the negotiation of FTAs with investment chapters in the region and, although these IIAs provide additional scope for addressing related issues such as environmental and labour protection, it is too early to determine whether a broader FTA relationship promotes investment flows or provides greater protection from host state alteration or termination of the investment relationship.

If the government of a host state party to a Canadian IIA takes action which has a negative impact on Canadian FDI, the provisions of the IIA will be available to provide international law protection. However, even with IIA coverage, the extent of legal protection an IIA will provide when it is applied to settle an investment dispute is uncertain. For example, the facts of the case may not be sufficient to amount to a breach of the IIA, the governmental conduct may be permissible under an IIA exclusion, and arbitral tribunals interpreting IIAs may differ in their resolution of similar cases. Further, Latin American countries such as Venezuela, Bolivia and Ecuador are circumscribing their IIA commitments. While some Canadian investors will probably be affected by legal developments in these Andean nations, it is unlikely that most other Latin American and Caribbean states will move to materially limit their IIA commitments.

**Annex 1****Canada's IIAs with States in Latin America and the Caribbean**

(November 2008)

FIPA: foreign investment promotion and protection agreement

FTA-Inv: free trade agreement investment chapter

Note: overseas territories in the Caribbean are excluded

<b>COUNTRY</b>	<b>TYPE</b>	<b>DATE</b>
Argentina	FIPA: Early Model	In force 29 April 1993
Brazil		
Paraguay		
Uruguay	FIPA: NAFTA Model	In force 2 June 1999
Chile	FTA-Inv: Canada-Chile FTA (NAFTA Model)	In force 5 July 1997
Peru	FIPA: 2004 Model FTA-Inv: Canada-Peru FTA Ch 8 (NAFTA/2004 Model)	In force 20 June 2007 Signed 29 May 2008
Bolivia		
Ecuador	FIPA: NAFTA Model	In force 6 June 1997
Colombia	FTA-Inv: Canada-Colombia (NAFTA/2004 Model)	Signed 21 November 2008
Venezuela	FIPA: NAFTA Model	In force 28 January 1998
Panama	FIPA: NAFTA Model	In force 13 February 1998
Costa Rica	FIPA: NAFTA Model	In force 29 September 1999
Nicaragua		

COUNTRY	TYPE	DATE
El Salvador	FIPA (text not available)	Signed 31 May 1999 (not in force)
Honduras		
Guatemala		
Mexico	FTA-Inv: NAFTA Ch 11	In force 1 Jan 1994
Dominican Republic		
Antigua and Barbuda		
Bahamas		
Barbados	FIPA: NAFTA Model	In force 17 Jan 1997
Belize		
Dominica		
Grenada		
Guyana		
Haiti		
Jamaica		
St Kitts and Nevis		
St Lucia		
St Vincent and the Grenadines		
Suriname		
Trinidad and Tobago	FIP: NAFTA Model	In force 8 July 1996
Cuba		

**Annex 2****Comparison of Canada's and the United States' IIAs with States in Latin America and the Caribbean**

(November 2008)

BIT: bilateral investment treaty

FIPA: foreign investment promotion and protection agreement

FTA-Inv: free trade agreement investment chapter

Note: overseas territories in the Caribbean are excluded

COUNTRY	CANADA/TYPE	UNITED STATES/TYPE
Argentina	FIPA	BIT
Brazil		
Paraguay		
Uruguay	FIPA	BIT
Chile	FTA-Inv	FTA-Inv
Peru	FIPA FTA-Inv (signed)	FTA-Inv (pending implementation)
Bolivia		BIT
Ecuador	FIPA	BIT
Colombia	FTA-Inv (signed)	FTA-Inv (pending congressional approval)
Venezuela	FIPA	
Panama	FIPA	BIT FTA-Inv (pending congressional approval)
Costa Rica	FIPA	FTA-Inv (not implemented)

<b>COUNTRY</b>	<b>CANADA/TYPE</b>	<b>UNITED STATES/TYPE</b>
Nicaragua		BIT (signed) FTA-Inv
El Salvador	FIPA (signed)	BIT (signed) FTA-Inv
Honduras		BIT FTA-Inv
Guatemala		FTA-Inv
Mexico	FTA-Inv	FTA-Inv
Dominican Republic		FTA-Inv
Antigua and Barbuda		
Bahamas		
Barbados	FIPA	
Belize		
Dominica		
Grenada		BIT
Guyana		
Haiti		BIT (signed)
Jamaica		BIT
St Kitts and Nevis		
St Lucia		
St Vincent and the Grenadines		
Suriname		
Trinidad and Tobago	FIPA	BIT
Cuba		

**Annex 3****Canada's IIAs and IIA Negotiations with States in Latin America and the Caribbean**

(November 2008)

FIPA: foreign investment promotion and protection agreement

FTA-Inv: free trade agreement investment chapter

Note: overseas territories in the Caribbean are excluded

<b>COUNTRY</b>	<b>TYPE</b>	<b>DATE</b>
Argentina	FIPA: Early Model	In force 29 April 1993
Brazil		
Paraguay		
Uruguay	FIPA: NAFTA Model	In force 2 June 1999
Chile	FTA-Inv: Canada-Chile FTA (NAFTA Model)	In force 5 July 1997
Peru	FIPA: 2004 Model FTA-Inv: Canada-Peru FTA Ch 8 (NAFTA/2004 Model)	In force 20 June 2007 Signed 29 May 2008
Bolivia		
Ecuador	FIPA: NAFTA Model	In force 6 June 1997
Colombia	FTA-Inv: Canada-Colombia FTA (NAFTA/2004 Model)	Signed 21 Nov 2008
Venezuela	FIPA: NAFTA Model	In force 28 Jan 1998
Panama	FIPA: NAFTA Model Canada-Panama FTA negotiations	In force 13 Feb 1998
Costa Rica	FIPA: NAFTA Model	In force 29 Sept 1999
Nicaragua	Canada-CA4 FTA-Inv negotiations	

COUNTRY	TYPE	DATE
El Salvador	FIPA (text not available) Canada-CA4 FTA-Inv negotiations	Signed 31 May 1999 (not in force)
Honduras	Canada-CA4 FTA-Inv negotiations	
Guatemala	Canada-CA4 FTA-Inv negotiations	
Mexico	FTA-Inv: NAFTA Ch 11	In force 1 Jan 1994
Dominican Republic	Canada-DR FTA-Inv negotiations	
Antigua and Barbuda	Canada-CARICOM FTA-Inv negotiations	
Bahamas	Canada-CARICOM FTA-Inv negotiations	
Barbados	FIPA: NAFTA Model Canada-CARICOM FTA-Inv negotiations	In force 17 Jan 1997
Belize	Canada-CARICOM FTA-Inv negotiations	
Dominica	Canada-CARICOM FTA-Inv negotiations	
Grenada	Canada-CARICOM FTA-Inv negotiations	
Guyana	Canada-CARICOM FTA-Inv negotiations	
Haiti	Canada-CARICOM FTA-Inv negotiations	
Jamaica	Canada-CARICOM FTA-Inv negotiations	
St Kitts and Nevis	Canada-CARICOM FTA-Inv negotiations	
St Lucia	Canada-CARICOM FTA-Inv negotiations	
St Vincent and the Grenadines	Canada-CARICOM FTA-Inv negotiations	
Suriname	Canada-CARICOM FTA-Inv negotiations	
Trinidad and Tobago	FIPA: NAFTA Model Canada-CARICOM FTA-Inv negotiations	In force 8 July 1996
Cuba		

# CHINESE INVESTMENT IN THE GLOBAL RESOURCE SECTOR, UTILISING AUSTRALIA AS AN ILLUSTRATION: A TIME FOR REASON, NOT FEAR

Jonathan Greenacre\* and Thomas Chiu\*

## Abstract

China's strong economic growth has led to massive global demand for resources. As a result, Chinese direct investment in the global resource sector has increased rapidly. Australian resource companies have been a particular target. Governments and resource companies have mixed feelings about the growing Chinese investment in resource companies. On one hand is the desire to encourage foreign direct investment and reap its associated economic benefits. On the other hand is the concern that Chinese direct investment is being funded and coordinated by the Chinese Government in order to secure China's long-term strategic goals.

This paper describes various manifestations of Chinese state capitalism, such as the Chinese sovereign wealth fund, and examines the risks and benefits of encouraging Chinese direct investment. The paper then identifies three 'Pressure Points' in Australia's foreign direct investment framework that are likely to cause tension between Australia and China. The authors argue that extensive public debate is required on this topic and that any reforms made to the Australian foreign investment system should be based on reason, rather than fear.

## 25. Introduction

As observed by the *The Economist*:

China, with about a fifth of the world's population, now consumes half of its cement, a third of its steel and over a quarter of its aluminium. Its imports of many natural resources are growing even faster than its bounding economy. Shipments of iron ore, for example, have risen by an average of 27% a year for the past four years. Western mining firms are enjoying a sustained boom.<sup>1</sup>

But, *The Economist* says:

China's sudden global reach is generating as much anxiety as prosperity. In 2005 America's congressmen, citing nebulous national-security concerns, scuppered the proposed takeover of Unocal, an American oil firm, by CNOOC, a state-owned Chinese one. The opposition candidate in Zambia's presidential election in 2006 made a point of attacking the growing Chinese presence in the country. Residents of Russia's far east fear

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\* Jonathan Greenacre is a graduate lawyer at Clayton UTZ Lawyers, Sydney, Australia.

\* Dr Thomas Chiu is the principal of Thomas Chiu & Associates, Lawyers & Notaries, and one of the founders of the Chancellor Legal Group. Dr Chiu lectures in law at a leading law school in Sydney on a casual basis. He holds several adjunct professorial appointments in China and Australia.

<sup>1</sup> Edward McBride, 'China's Quest for Resources, A Ravenous Dragon', vol 389, no 8660, at <<http://www.economist.com> at 13 March 2008>.

that China is planning to plunder their oil and timber and perhaps even to colonise their empty spaces.<sup>2</sup>

*The Economist* adds that:

Some non-governmental organisations worry that Chinese firms will ignore basic legal, environmental and labour standards in their rush to secure resources, leaving a trail of corruption, pollution and exploitation in their wake. Western companies fret that the Chinese state-owned firms with which they suddenly find themselves competing have an agenda beyond commercial gain ...<sup>3</sup>

Resources companies around the world have mixed feelings about the growing Chinese investment in resources. In the light of what *The Economist* observed, China's move is likely to put increasing strain on the foreign investment system of the host countries. This strain has already led to the delay or refusal of Chinese investment proposals, causing tension between China and the host countries. Absent reform to the system, such tension is likely to increase as China, increasingly eager to meet its energy needs, seeks access to additional resources in a foreign country.

Tension between Australia and China is likely to centre on three aspects of Australia's foreign investment system ('Pressure Points'). First, the Australian Treasurer has the right to refuse a Chinese investment on the ground of inconsistency with Australia's 'national interest'. This is likely to frustrate an increasing number of Chinese investors whose proposals may be refused upon inappropriate political or commercial grounds. Second, the Takeovers Panel may determine that a large number of takeovers are unacceptably co-ordinated between two 'associated' Chinese investors. This is because most Chinese companies have a common owner, the state, which co-ordinates their investments as a means of maintaining economic growth. These decisions would be controversial because of the Takeovers Panel's self-professed difficulties in determining the 'associate test'. The finding that companies are associates is usually achieved through the use of 'inferences', so the decisions will often be open to dispute by the Chinese on factual grounds. Third, enforcing judgments upon assets held by China's sovereign wealth fund will be challenging because doing so requires numerous political and diplomatic steps and due to the vagaries of international politics, enforcement of judgements has little certainty of success.

The danger for Australia's economic growth is that, in seeking to ease concerns about rising Chinese ownership of Australian resources companies, the Australian Government may engage in 'knee-jerk' protectionist legal reform or otherwise apply the existing foreign investment rules in ways which prevent Australia from obtaining the full benefits of Chinese investment. Instead of doing so, the government and key industry leaders should encourage research and public debate into state-driven investment, particularly from China; develop an understanding of the benefits of such investment as well as potential political or commercial risks; and only then perform objective, reasoned amendments to Australia's foreign investment laws, if required.

This paper explores this argument in four parts. The first argues that Australia needs to shift from viewing Chinese investment on a case-by-case basis to understanding that it faces large

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<sup>2</sup> *Ibid.*

<sup>3</sup> *Ibid.*

and sustained Chinese investment which, in contrast to most other investment faced up to this point, will have a high degree of state involvement. The second emphasises the type of commercial and political benefits and risks of Chinese investments which should be considered when administering the foreign investment system and considering reform to the system. The third forecasts three ‘Pressure Points’ in Australia’s investment systems which are likely to arise from those benefits and risks. The fourth suggests measures to stimulate the type of debate which is required to ensure that legal reform to the foreign investment system, if required, is based on reason rather than fear.

## **26. Background: China’s ‘Go Abroad’ Policy at Work in Australia**

### **xliv. The Government’s Balancing Act**

The Rudd Government is obliged to perform the delicate balancing act of encouraging investment while soothing community concerns over foreign ownership. The following guidelines, published in April 2008 by the Foreign Investment Policy Division of the Treasury, encapsulate the government’s challenge:

The Government’s approach to foreign investment policy is to encourage foreign investment consistent with community interest ... the Government recognises community concerns about foreign ownership of Australian companies. One of the objectives of the Government’s foreign investment policy is to balance these concerns against the strong economic benefits to Australia that arise from foreign investment.<sup>4</sup>

Thus far, the Rudd Government has sought to apply this balancing act to Chinese investment by courting Chinese investors without making formal commitments. On one hand, the government is working hard at communicating that it welcomes foreign investment, including from China. For example, Federal Resources Minister Martin Ferguson has recently outlined Australia’s broad open-arms policy with regard to Chinese investment. He stated: ‘[W]e welcome foreign investment, particularly when it is in Australia’s national interest and leads to Australian resources being developed for the benefit of all Australians. We are firmly committed to open and transparent markets when it comes to global resources, trade and investment’.<sup>5</sup>

Australia has matched this rhetoric with actions. For example, Trade Minister Simon Crean MP has engaged Chinese demands to lower Australian investment barriers as part of negotiations over a bilateral free trade agreement. He has also stated that the government would consider demands by China to invest almost AUD\$1 billion at a time without having to seek approval from the Foreign Investment Review Board.<sup>6</sup>

On the other hand, the government is refusing to engage in formal commitments to Beijing over the extent of China’s foreign investment in Australia. For example, the China Development Bank has recently called for Canberra and Beijing to adopt a 5–10-year plan for

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<sup>4</sup> Department of Treasury, *Australia’s Foreign Investment Policy*, Canberra, January 2007, at <<http://www.firb.gov.au>> on 28 May 2008.

<sup>5</sup> Kevin Andrusiak and Andrew Trounson, ‘Beijing Takes Over BHP Raid Plans’, *Australian*, 17 April 2008, p 6.

<sup>6</sup> Andrew Burrell, ‘Chinese State Investment’, *Australian Financial Review*, 22 April 2008, p.16.

Chinese investment in Australia's mining sector.<sup>7</sup> Acting Treasurer Lindsay Tanner avoided responding directly by publicly stating that the government remains committed to the current process of assessing foreign investments on a case-by-case basis.<sup>8</sup>

However, Australia needs to realise that a case-by-case or individual approach to Chinese investment is unfeasible due to the depth of China's needs for resources and the lengths to which the Chinese Government will go to obtain reliable access to these resources.

#### **xlv. China's Needs for Australia's Resources**

China's resource demands are already large. The country currently represents global demand for more than 45% of seaborne iron ore, 20% of copper, 25% of aluminium and 17% of nickel.<sup>9</sup> A 2008 report by McKinsey and Co suggests that by 2025, 350 million people will be added to China's urban population,<sup>10</sup> requiring five billion square metres of road, 170 mass transport systems, 40 billion square metres of floor space and up to 50,000 new skyscrapers.<sup>11</sup> Such rapid industrialisation and urbanisation will require unprecedented construction which, in turn, will require vast amounts of resources and materials. For example, China's per capita steel demand is expected to triple from current levels. More generally, the growing urbanisation will mean China's urban demand for resources will double by 2025.<sup>12</sup>

Australia must realise that this enormous rise in demand is more than a temporary anomaly or short-term change which can continue to be dealt with on a case-by-case basis. Instead, it represents a structural change in the global marketplace. As the Minerals Council of Australia found in a 2005 report:

Essentially, what we are seeing is a profound shift in the global market in terms of demand ... That is largely a consequence of the impact of the emerging economies in North Asia, China in particular, which aims to quadruple its GDP by 2020, which equates to about a seven percent per annum growth. We are seeing China following the path of industrialisation and urbanisation that history records occurred in the 1890s in the United States of America and again in the 1950s and 1960s in the United States but also Japan and South Korea.<sup>13</sup>

From its lack of activity, the Rudd Government appears to be hoping that the Chinese will be content to continue to adopt a piecemeal approach when investing in Australian resources companies. However, as the next section demonstrates, this hope is misplaced. Instead, the Chinese Government is deliberately and increasingly driving its companies' efforts to obtain access to such materials and is poised to intensify its efforts in the future.

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<sup>7</sup> *Ibid* at p 16.

<sup>8</sup> *Ibid* at 17.

<sup>9</sup> Jonathan Woetzel et al, 'Preparing for China's Urban Billion: Summary of Findings', McKinsey Global Institute, March 2008, p 11, at <<http://www.mckinsey.com>>.

<sup>10</sup> *Ibid* p 14

<sup>11</sup> *Ibid* p 16.

<sup>12</sup> *Ibid* p 20.

<sup>13</sup> Commonwealth Committee Hansard, 2005, vol XLIX, at [26].

#### xlvi. **The Government's Willingness to Obtain Resources: China's 'Go Abroad' Policy and State Capitalism**

In the late 1990's, the Chinese Government embarked upon a policy entitled 'Zou Chuqu', or 'Go Out', often translated as the 'Go-Abroad' policy. This policy encourages Chinese companies with comparative advantages to engage in overseas direct investment and acquisitions. The objectives of the policy are to secure access to important raw materials such as oil, natural gas, metals, ores and coal for domestic use.<sup>14</sup>

As China's raw materials shortage has grown and pressure on the exchange rate has intensified, the 'Go-Abroad' policy has become increasingly prominent. In a journal article provocatively titled 'Are Chinese Companies Taking Over the World?', Mitchell Silk and Richard Malish from Allen & Overy's China Group argue that Chinese companies are quickly becoming very active in acquiring stakes in major companies. For example, Chinese foreign direct investment jumped from \$US1.8 billion in 2004 to \$US17.8 billion in 2006, and is predicted to grow by 22% per annum up to 2010.<sup>15</sup> As a result, by the end of 2004, over 5000 Chinese enterprises had invested directly in nearly 200 countries or regions.<sup>16</sup>

Strikingly, Silk and Malish's article was written in early 2006, before the recent flurry of Chinese investment. China was far more active in 2007 and early 2008, with a variety of equity investments, including the Industrial and Commercial Bank of China's US\$5.5 billion purchase of a 20% stake in South Africa's Standard Bank Group and the China Investment Corporation's purchase of a US\$3 billion, 10% stake in United States private equity firm Blackstone.<sup>17</sup>

These equity investments have been dwarfed by the number and size of Chinese companies' investments in resource companies, particularly in 2007. Amongst other purchases during this year, China Minmetals Corporation and Jiangxi Copper Co Limited purchased the Northern Peru Copper Corporation for US\$1.15 billion; China Metallurgical Corporation successfully purchased a copper mine in Afghanistan for US\$3.7 billion; and Chinalco recently acquired an exploration area for bauxite with exploitable reserves of US\$2 billion in Kenya in Africa.<sup>18</sup>

The Rudd Government appears to have recognised the Chinese Government's clear objectives of obtaining access to resources. For example, on March 3 2008, Prime Minister Kevin Rudd stated: 'China's long-term strategic interest is to secure its own resource and energy interests into the very long-term future'.<sup>19</sup> However, there appears to be little understanding within Australia about the Chinese Government's willingness to support its domestic companies' attempts to obtain access to resources. In a paper published in the *Law and Business Review of the Americas* in 2008, Gerard Lyons discussed the rise of sovereign

<sup>14</sup> James Laurenceson, 'Chinese Investment in Australia' (2008) 27 *Economic Policy* [91].

<sup>15</sup> Mitchell Silk and Richard Malish, 'Are Chinese Companies Taking Over the World?' (2006-07) 7 *Chicago Journal of International Law* 105 at 108.

<sup>16</sup> *Ibid* at 109.

<sup>17</sup> Elisabeth Sexton, 'Enter the Hungry Dragon', *Sydney Morning Herald*, 9 February 2008, <<http://www.business.smh.com.au/business>>.

<sup>18</sup> *Ibid*.

<sup>19</sup> Rowan Callick, 'Time to Mull China Investment Plan', *Australian Financial Review*, 3 March 2008, p 11.

wealth funds<sup>20</sup> and defined the term ‘state capitalism’ which, in his view, describes ‘the use of Government controlled funds to acquire strategic stakes around the world’.<sup>21</sup> Lyons is correct in arguing that much state-supported foreign investment takes the form of sovereign wealth funds and will increasingly do so in the future.<sup>22</sup>

However, focusing on sovereign wealth funds alone fails to account for the variety of state-driven investment in international finance. China’s methods of state capitalism are particularly varied. They manifest in the following forms, most of which have been used to invest in Australian resources companies. As will be demonstrated, all of these methods are causing tension between the countries because of the involvement of the Chinese Government.

First, the Chinese Government supports its companies through various non-financial methods. One such method is technical assistance. For example, Lenovo received technical assistance for its computers and service from more than 58,000 staff of its former state-owned parent, the Chinese Academy of Science.<sup>23</sup> Furthermore, some state-owned enterprises also receive support for global campaigns to recruit top executives and assistance with corporate matchmaking.<sup>24</sup> For example, when European steel maker Arcelor and Tokyo-based Nippon Steel were looking to invest in China, Beijing led them to Shanghai Baosteel, which needed technological assistance making high-grade steel for car manufacturing. The result is a US\$785 million plant in Shanghai that produces 1.2 million tonnes of cold rolled steel each year.<sup>25</sup>

The second element of Chinese state capitalism occurs when Chinese companies, both state-owned and nominally private, obtain favourable lending rates. Some of this lending comes from China’s commercial banks.<sup>26</sup> For example, in its bid for Unocal in 2005, state-owned China National Offshore Oil Corporation would have received a US\$7 billion intercompany loan from its state-owned majority shareholder, consisting of an interest-free US\$2.5 billion bridging loan to have been refinanced through the sale of shares in two years, and the remainder payable over 30 years at a 3.5% interest rate.<sup>27</sup> When Shanghai Auto acquired a

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<sup>20</sup> While there is no single universally-accepted definition of these bodies, it is generally accepted that sovereign wealth funds — or state investment funds — are financial vehicles owned by states which hold, manage, or administer public funds and invest them in a wider range of assets of various kinds. Their funds are mainly derived from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves at central banks: see George Stephanov Georgiev, ‘The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security’ (Winter 2008) 14 *Yale Journal on Regulation* [227].

<sup>21</sup> Gerard Lyons, ‘State Capitalism: The Rise of Sovereign Wealth Funds’ (July 2007) 14 *Law and Business Review of the Americas* [184].

<sup>22</sup> For a useful overview of the rise of sovereign wealth funds, see Mark Allen and Jaime Caruana, ‘Sovereign Wealth Funds — A Work Agenda’ (29 February 2008) 12 *International Monetary Fund* [52].

<sup>23</sup> Silk and Malish, *supra* n 15, at 108.

<sup>24</sup> Frederick Balfour, ‘The State’s Long Apron Strings’ (22 August 2005) 76 *Business Weekly*, at <<http://www.businessweek.com>>.

<sup>25</sup> *Ibid.*

<sup>26</sup> Silk and Malish, *supra* n 15, at 115.

<sup>27</sup> *Ibid* at 116.

stake in the Korean manufacturer Sangyong Motors, 66% of the acquisition was financed through preferential loans from three state-owned banks.<sup>28</sup>

Chinese companies can also take advantage of loans from China's policy banks. China formed three policy banks in 1999 as part of a restructuring of its banking system: the China Development Bank, which focuses on infrastructure and financing; the Export Import Bank, specialising in trade finance; and the Agricultural Development Bank, which provides funds for rural development. Despite their primary policy mandates of domestic work, these banks have also committed themselves to providing easier credit for enterprises seeking foreign acquisitions. For example, in November 2004, the Export Import Bank announced that it would earmark a special portion of its budget for overseas direct investment in some key overseas projects and provide a 2% interest rate discount to participating Chinese companies.<sup>29</sup> The China Development Bank has also penned strategic partnership agreements with a number of state enterprises and, in 2006, committed to provide US\$8.6 billion in loans for 17 overseas investment projects.<sup>30</sup>

The third form of Chinese state capitalism occurs when state-owned enterprises obtain direct contribution to capital.<sup>31</sup> Around 70% of capital is reserved for state-owned enterprises.<sup>32</sup> James Kynge states that the relationship between state-owned banks and political bodies is so close that state-owned companies have almost limitless access to capital:

[Some Chinese bankers state] that the decisions the banks take on whether to lend money to companies are based solely on the judgment of whether that company will be able to repay its debts plus interest. Following several years of reform, this claim may be more true than it used to be, but the reality is still that if an important state company needs a loan, or a big state project needs funding, the 'big four' can be counted on to oblige, regardless of commercial considerations.<sup>33</sup>

State-owned companies are beginning to acquire interests in Australian companies. For example, the two largest Chinese direct investors in Australia, China Trust and Investment Company and Sinosteel Australia, are state-owned companies.<sup>34</sup> Furthermore, on 18 January 2008, Yilgarn Infrastructure announced that the Australian Government had approved investment agreements signed late in 2007 between Yilgarn Infrastructure and five major Chinese companies, relating to the estimated AUD\$3 billion Oakajee Port and Rail Project in Western Australia's mid-west region.<sup>35</sup> It was the first time such a big consortium of Chinese state-owned enterprises had invested in an Australian company. Finally, on 4 February 2008, the state-owned holding company Chinalco teamed up with American company Alcoa to pay US\$14.5 billion for a 12% stake in Rio Tinto's London shares, equating to 9% of the dual-listed Rio-Tinto Group ('Chinalco-Rio Tinto Deal').<sup>36</sup>

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<sup>28</sup> John Lunding, 'The Long and Short of China's Banks' (26 August 2005) 76 *Business Weekly*, at <<http://www.businessweek.com>>.

<sup>29</sup> Silk and Malish, *supra* n 15, at 116.

<sup>30</sup> *Ibid* at 115.

<sup>31</sup> *Ibid* at 110.

<sup>32</sup> Nicholas Lardy, 'China's Worsening Debts', *Financial Times*, 22 June 2001, p 13.

<sup>33</sup> James Kynge, *China Shakes the World: The Rise of a Hungry Nation*, 2005.

<sup>34</sup> Laurenceson, n 14, at 90.

<sup>35</sup> Media statement, 'Commonwealth Approves China's Oakajee Port and Rail Investment', 18 January 2008, at <<http://www.yilgarninfrastructure.com.au>>.

<sup>36</sup> James Hall et al, 'Chinese Fears over Rio Tinto' (February 2008) *Federal Review*, p 21.

The fourth manifestation of Chinese state capitalism involves government departments investing directly in foreign assets. For example, the State Administration of Foreign Exchange (SAFE) is a Chinese Government department which invests China's foreign currency exchange reserves. In 2007, SAFE is believed to have taken small stakes, estimated at around 1%, in each of National Australia Bank, Commonwealth Bank of Australia and Australia and New Zealand Banking Group.<sup>37</sup>

The final form of Chinese state capitalism involves China's investments which occur through its sovereign wealth fund, the China Investment Corporation (CIC). Formed on September 29 2007 and with US\$200 billion in initial capital, the CIC is one of the largest sovereign wealth funds in the world.<sup>38</sup> Since its creation, the CIC and its subsidiaries have already made several investments, including the purchase of 9.9% of the United States financial firm, Morgan Stanley, on December 19 2007.<sup>39</sup>

The Chinese Government's willingness to support its companies' worldwide acquisitions in an effort to obtain access to resources, particularly in Australia, is evidence that a case-by-case approach to Chinese investment is clearly unfeasible. With its foreign reserves of around US\$1.7 trillion,<sup>40</sup> and, as has been described above, a willingness to use various means at its disposal to meet its enormous energy demands through investment in resources companies, the result will be increased state-driven Chinese investment.

Australia will continue to be a prime target for increased Chinese investment, mainly because of the ability of Australia to meet at least some of China's enormous and growing demand for resources. The two economies are often referred to as 'natural partners'.<sup>41</sup> One commentator has described the relationship as one of 'natural economic affinity'.<sup>42</sup> This affinity is particularly strong in the field of resources. As the Chinese Ambassador to Australia stated in 2004, the basis of this complementarity lies in the view that 'Australia has rich reserves of energy and mineral resources while China has growing demand'.<sup>43</sup>

In light of this synergy, Australia needs to determine how to manage foreign investment from its increasingly resource-hungry neighbour without succumbing to unnecessary protectionist sentiment at home. The United States has already demonstrated how difficult this challenge can be.

#### **xlvi. What to Learn from the United States: the Politics of Fear**

In the January 17 2008 edition of *The Economist*, the editors argued that most target countries for sovereign wealth funds are likely to engage in protectionist legal backlash against these funds in order to ease popular fear of foreign ownership. They conclude 'in politics, appeals

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<sup>37</sup> Andrew Burrell, 'Chinese State Investment', *Australian Financial Review*, 22 April 2008, p 16.

<sup>38</sup> Mark Martin, 'CRS Report for Congress: China's Sovereign Wealth Fund' (2008) *Congressional Research Service* [12].

<sup>39</sup> *Ibid* at 13.

<sup>40</sup> 'China Economy: An Embarrassment of Riches' (9 June 2008) *Economist Intelligence Unit — Viewswire 7*, at <<http://www.economist.com>>.

<sup>41</sup> See, for example, Ambassador Fu Ying, 'Address to the National Press Club', 28 July 2004, *National Press Club* 1.

<sup>42</sup> Graeme Thomson, 'Trade Policy Issues' (13 August 2004) *Australia-China Free Trade Agreement Conference* 21.

<sup>43</sup> *Supra* n 41.

to fear usually sell better than those to reason'.<sup>44</sup> While *The Economist* was writing specifically about sovereign wealth funds, the response of the United States to an attempted Chinese takeover of an American company indicates that fear of foreign ownership can easily lead to protectionist sentiment when it comes to other aspects of Chinese investment.

In 2005, state-owned China National Offshore Oil Corporation (CNOOC) made a US\$18.5 billion bid for United States-based Unocal. The United States public and Government were highly alarmed. Forty congressmen protested the deal on energy security concerns.<sup>45</sup> Four bills were introduced in Congress that directly sought to obstruct or prohibit CNOOC's bid for Unocal. Numerous congressmen voiced concern that the CNOOC's financing represented an unfair government subsidy.<sup>46</sup> The American media became stridently fearful and protectionist. For example, financial journalist James Surowiecki wrote: '[W]ere China so inclined, it could buy Ford, G.M., Volkswagen, and Honda, and still have a little money left over for ice cream'.<sup>47</sup>

As a result, the United States passed the strongly protectionist Foreign Investment and National Security Act of 2007.<sup>48</sup> This Act requires that the Committee on Foreign Investment in the United States (CFIUS) investigate any foreign investment transaction (including mergers, acquisitions, or takeovers) which would result in 'foreign control of any person engaged in interstate commerce in the United States' or foreign control of 'critical infrastructure that could impair national security'.<sup>49</sup> The new law also adds new criteria for CFIUS to use when determining if an investigation is warranted, including whether the transaction is 'foreign'.<sup>50</sup> The Chinese investors eventually withdrew the investment offer, citing the 'unprecedented political opposition that followed the announcement of [the] proposed transaction' which, in its view was 'regrettable and unjustified'.<sup>51</sup>

Protectionist legal reform would be likely in Australia in the event of a CNOOC-type investment because, like in the United States at the time, there has been little genuine public debate and discussion about Chinese state capitalism. For example, Stephen Grenville, former Deputy Governor of the Reserve Bank, has recently asked: 'Who's thinking about these issues, and where is the debate taking place?'.<sup>52</sup> Former Foreign Minister Alexander Downer is also intrigued by the lack of public debate, announcing: 'It is quite surprising. I am amazed, regardless of what the Government may say or think, that there is just not much focus on it'.<sup>53</sup>

However, the commercial stakes are too high for Australia to risk the type of damaging political fallout which occurred between the United States and China over CNOOC's bid. The relationship with China is central to Australia's economic future, now increasingly dependent on Chinese demand for its exports, particularly iron ore and coal. China's ability to

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<sup>44</sup> 'The Invasion of the Sovereign Wealth Funds', *The Economist*, 17 January 2008, p 4.

<sup>45</sup> Justine Blum, 'CNOOC Request US Security Scrutiny', *Washington Post*, 28 June 2005, p 41.

<sup>46</sup> Steve Lohr, 'The Big Tug of War Over Unocal', *New York Times*, 6 July 2005, p 6.

<sup>47</sup> James Surowiecki, 'Sovereign Wealth World', *New Yorker*, 26 November 2007, p 12.

<sup>48</sup> Foreign Investment and National Security Act (2007) Pub L No 110-49, 121 Stat 246.

<sup>49</sup> For more information about the Foreign Investment and National Security Act (2007) and CFIUS, see J K Jackson, 'CRS Report for Congress: Committee on Foreign Investment in the United States' (updated 8 April 2008), Congressional Research Service, at <<http://www.fas.org/sgp/crs/natsec/RL33388.pdf>>.

<sup>50</sup> Martin, *supra* n 38, at 5.

<sup>51</sup> *CNOOC Limited to Withdraw Unocal Bid* (2 August 2005), CNOOC Limited, at <<http://www.cnooltd.com>>.

<sup>52</sup> Colleen Ryan, 'China's Coming to Dinner', *Weekend Australian Financial Review*, 24-27 April 2008, p 51.

<sup>53</sup> *Ibid* at 48.

pay ever-higher prices for Australian resources is the main reason that Australian economic growth has continued, even as growth in the United States has faltered.<sup>54</sup>

To avoid this fallout, Australia needs to understand the sort of commercial or political benefits and risks which arise from Chinese investment before a major CNOOC-Unocal-style proposal occurs. The next section looks at these benefits and risks.

## **27. Benefits and Risks of Chinese Investment**

### **xlvi. Benefits of Chinese Investment**

#### **a. Access to Capital and Infrastructure**

Australia requires capital to fully maximise its resources and thus fully exploit the resources boom. As Rowan Callick, Beijing correspondent for *The Australian* newspaper, recently wrote:

Australia needs to have ore available at ports for shipment. India and Africa, as well as Brazil, are busy building new mines. BHP Billiton and Rio Tinto are doubling their present output and more, in the next few years. They have the experience and the access to capital to do so on their own. Crucial components though they are, they remain exceptions to the overall emerging pattern.<sup>55</sup>

So although large players like BHP and Rio Tinto may not require it, Chinese investment can provide Australian miners, particularly smaller players, with the capital they require to finance new projects and provide resources to Asian markets more quickly and effectively than their international rivals. For example, as stated by Jo Clarke:

[Smaller mining companies] insist that Asian investment is the surest way to finance new projects in the current market and without them, Australia's national resources will be left undeveloped in the middle of the biggest commodity boom in living memory. Australia will lose out to its resources-rich rivals in South America and Africa, and the government will lose out on billions of dollars of taxes and royalties.<sup>56</sup>

This investment is particularly important in the current context. The 'credit crunch' and weakening of the equity markets have made it extremely difficult for smaller miners to raise finance for new mines and infrastructure, particularly in Australia's undeveloped regions. As Hartleys mining analyst Andrew Muir states: 'Chinese investment is an avenue for companies to fund their operations, particularly given recent changes in market [debt and equity] sentiment'.<sup>57</sup>

Chinese investment also helps smaller miners to quickly become larger entities and thus avoid takeover attempts from international players. For example, small mining company Sandfire Resources was unable to secure long-term funding from the debt or equity markets. Sandfire Resources director Karl Simich stated that foreign investment which he eventually

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<sup>54</sup> Jennifer Hewett, 'Tiptoe Across a Minefield', *The Australian*, 26 April 2008, at <<http://www.theaustralian.news.com.au>> on 26 April 2008.

<sup>55</sup> Callick, n 19, at 10.

<sup>56</sup> Jo Clarke, 'The Very Thought of China', *Weekend Australian Financial Review*, 17–18 May 2008, p 4.

<sup>57</sup> *Ibid* at 24.

procured protects his company from more hostile approaches should it ever make a big discovery: ‘Otherwise we might get consumed in the whole process and disappear. With a partner we can develop anything we find, for the sake of the country and of the projects themselves’.<sup>58</sup>

As a result, some industry leaders are calling for more Chinese investment. For example, Duncan Calder, Western Australian president of the Australia China Business Council, recently stated: ‘[N]ow is the time to work [with the Chinese] to build bridges in Australia as well as to build ports, rail, heavy equipment, power stations, downstream processing and, ultimately, steel mills’.<sup>59</sup>

## **b. Access to China’s Domestic Market**

Australia has considerable interest in gaining access to the Chinese financial services sector. As the Australian Senate Foreign Relations Committee commented in 2005:

The services sector in particular holds great promise for China and Australia. China’s services sector is underdeveloped. On the other hand, Australia is an advanced economy with the service sector having a predominate place in generating economic growth.<sup>60</sup>

Australia has a higher chance of obtaining access to the Chinese services sector by opening its own market to investment. It would be hypocritical to erect barriers to Chinese foreign investment while demanding open access to their market. The Australian Government has already realised this point. Trade Minister Simon Crean MP recently admitted that his negotiations with China over opening Australia to additional foreign investment were partly an attempt to encourage China to offer Australia the same treatment, stating: ‘This is a two-way thing. We also have interests in freeing up restrictions in Australian investments into China’.<sup>61</sup>

Despite these benefits of Chinese investments in the Australian resources sector, it is necessary to also consider the dangers of permitting extensive Chinese investment and thus the importance of maintaining some control over foreign investment.

## **xlix. The Risks**

### **a. Loss of Domestic Control**

Maintaining ownership of domestic companies is an important way of generating national wealth. For example, BHP, widely considered a ‘national champion’<sup>62</sup> generates considerable resources from Australia. Over 50% of its assets are in Australia, 49% of profit before

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<sup>58</sup> *Ibid.*

<sup>59</sup> Callick, n 19, at 14.

<sup>60</sup> Senate Foreign Affairs Committee, Parliament of Australia, *Opportunities and Challenges: Australia’s Relationship with China* (2005) at [3.10]; See, for example, Alan Oxley, ‘Good FTAs Should be Like Share Prices — Anticipate Future Developments: Trends in Trade and Investment Between China and Australia’, presentation to the China Australia Free Trade Agreement Conference (August 2004) 2. See at <<http://www.apec.org.au/docs/china04Oxley.pdf>> on 3 June 2008.

<sup>61</sup> Andrew Burrell, ‘Crean May Open Door to Chinese Money’, *Australian Financial Review*, 21 April 2008, p 1.

<sup>62</sup> Ryan, n 52, at 12.

interest and taxation is generated by Australian-based assets, and over 495,000 Australian retail BHP Limited shareholders hold AUD\$36 billion worth of shares.<sup>63</sup>

Other countries have ‘lost’ all national champions. For example, in the view of BHP Billiton chairman Don Argus, foreign investment has ‘hollowed out’ Canadian ownership of its resources companies, particularly nickel giants Inco and Falconbridge:

You saw perhaps a lot of their resource companies hollowed out and owned by foreign entities. I would hate that to happen here. People will say ‘there he is being xenophobic again’. I’m not. I’m being very pragmatic about it.<sup>64</sup>

The ease with which Chinese investors can buy Australian resources companies outlines the risk of Australia being ‘hollowed out’. The Chinalco-Rio deal in particular, evidences this point. As Andrew Burrell wrote in *The Australian Financial Review*:

China added a cool [AUD]\$1.8 billion each day to its foreign currency reserves in the first 3 months of 2008, just as the Rio shares were being purchased. In other words, it would have taken China just over a week to accumulate the money it needed to fund the stake. And the purchase would barely have put a dent in the country’s overall reserves, which have since reached a staggering \$1.79 trillion.<sup>65</sup>

Smaller miners are already being consumed by Chinese investors. Abra Mining managing director Jeff Moore stated that it had no choice but be swallowed by a Chinese investor, Hunan Nonferrous Metals Corporation, in 2007. In his view, agreeing to the takeover was the only way which the company could maintain its competitiveness. Mr Moore stated: ‘We can’t stand still ... In terms of the mining industry selling the farm to China, it’s possible’.<sup>66</sup>

Aside from this generic concern about foreign ownership, there is the more specific concern that most Chinese investments are made by state-owned companies, under the direction of government departments and financed by state-owned banks, as outlined in the section above on ‘state capitalism.’ As Colleen Ryan recently wrote:

China ... is governed by the Communist Party and its economic structure is an anathema to the West. There is a lack of transparency in the governance of large state-owned Chinese corporations and the big strategic corporations that are reaching outwards are all majority state-owned.<sup>67</sup>

Several issues then flow from Chinese state control of its investment vehicles.

#### **b. ‘Unfair’ Advantage**

Due to their political ties, Chinese companies can obtain access to very large amounts of money and other forms of support in ways which private European, American and Australian companies cannot. The US-China Economic and Security Review Commission is a

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<sup>63</sup> Don Argus ‘The Resources Sector’, presentation given to the Australian Shareholders Association, 5 March 2008, at 19.

<sup>64</sup> Kevin Andrusiak, ‘Chinese Firm Sought Cheaper Iron Ore Through Share Deal’, *Australian*, 3 June 2008, p 8.

<sup>65</sup> Burrell, n 61, at 16.

<sup>66</sup> Andrusiak, n 64, at 8.

<sup>67</sup> Ryan, n 52, at 26.

Congressional agency established specifically to investigate and report to the United States Congress on the national security implications of the trade and economic relationship between the two countries. The Commission has argued that favourable lending by Chinese banks or direct contribution of capital ‘amounts to a massive government subsidy for Chinese firms’.<sup>68</sup>

This advantage means that, in the long run, Chinese companies will have sufficient resources to make investment in Australian resources companies on a scale so large that Australian investment companies, such as Macquarie Bank, may be unable to compete.<sup>69</sup>

### c. Political Versus Commercial Considerations

There are suggestions that China’s investments are often more political than commercial. Some commentators argue that this issue is endemic to China’s commercial sector. For example, John Lee contends that politics, not commerce, dominates the rules of lending, stating that Chinese central banks operate to:

... maintain jobs for workers [of state-owned enterprises] who are the Party’s most loyal supporters, [and] to maintain support for managers [of state-owned enterprises] who are mainly Party members and supporters.<sup>70</sup>

This political motive allegedly extends to Chinese efforts to invest in ways that ensure that Chinese consumers ultimately pay a lower cost for resources. For example, there are suggestions that the Chinalco-Rio deal was engineered from Beijing to obtain cheaper prices for Chinese iron ore purchases.<sup>71</sup> When queried, Chinalco’s president, Xiao Yaqing did not explicitly deny that Chinese authorities influenced the decision to buy the Rio Tinto stake because of their concerns about the potential impact on Chinese steel producers of the dominant market power in iron of a combined BHP Billiton and Rio Tinto. Instead, Xiao insisted, unconvincingly, that the timing of the acquisition in Rio, particularly in the face of BHP’s takeover plans, was ‘a coincidence’.<sup>72</sup>

This issue feeds into the broader concern that the Chinese Government is investing in overseas companies to ultimately exert influence over the countries in which they operate. As stated in *The Economist*:

For some, the nub of it is that governments are less interested in money than in power. Kevin Hassett of the American Enterprise Institute illustrates the worries by imagining that China bought Citigroup. What if America sought to take sides in a conflict with Taiwan and China then threatened to shut the bank down?<sup>73</sup>

The author does not take a position on the normative question of whether increased Chinese investment should be permitted. However, the above discussion demonstrates that the issue of

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<sup>68</sup> US/China Economic and Security Review Commission, 9 November 2005, Rev 2 Congress, 109 Congress, First Session 39. See also Richard Macgregor, ‘China Remains Vulnerable to Liquidity Shock Despite Launching War on Bad Debt’ (4 May 2006) 11 *Financial Times* 12.

<sup>69</sup> John Garnaut, ‘China’s Rivers of Foreign Exchange Keep Flowing’, *Sydney Morning Herald*, 2 June 2008, p 22.

<sup>70</sup> John Lee, ‘The False Promise of “Market Socialism” in China’ (2008) 23 *Policy* [27].

<sup>71</sup> Geoff Kitney, ‘Off-Market Swoop a Study in Stealth’, *Australian Financial Review*, 4 February 2008, p 18.

<sup>72</sup> *Ibid.*

<sup>73</sup> *The Economist*, n 44, p 4.

Chinese investment is more complex than any simple argument that such investment is unequivocally welcome or unwelcome in Australia. So, any administration of the foreign investment system, or reforms to it, should involve a number of considerations rather than being performed in a hysteria-driven climate of the sort which occurred in the United States.

With this understanding, it is now necessary to explore the three likely 'Pressure Points' in Australia's investment system which are likely to arise from the benefits and risks of the Chinese investments described above. Again, such investigations should occur before a CNOOC-Unocal-type deal is attempted, which might spark off fear-driven reforms to the foreign investment system.

## **28. The Pressure Points**

### **I. The Foreign Acquisitions and Takeovers Act 1975 (Cth)**

The first pressure point to consider is the *Foreign Acquisitions and Takeovers Act 1975 (Cth)* (*Acquisitions Act*) and associated executive policy. Under the *Acquisitions Act*, a foreign investor must notify the Australian Government of investments of certain sizes.<sup>74</sup> Importantly though, state-owned enterprises, which include almost all big Chinese investors, are required to seek approval for any stake, no matter how small.<sup>75</sup> The most controversial aspect of the *Acquisitions Act* is the power which it provides the Treasurer, usually as advised by the Foreign Investment Review Board, to declare certain proposals to be inconsistent with the 'national interest', even if the proposals are not subject to formal prohibition under the *Acquisitions Act*.<sup>76</sup> In addition to the power to make such a declaration, the Treasurer can make an order that directs a person to dispose of acquired shares for failure to satisfy the 'national interest' test.<sup>77</sup>

Tension between Australia and China has recently begun to develop over the Treasurer's allegedly 'unreviewable' discretion over foreign investment decisions on the ground of national interest. The main concern is that his or her considerations may not properly account for the potential benefit to Australia or may be otherwise decided on inappropriate grounds. These grounds may cover a number of issues, but it is feasible that the Treasurer may determine the 'national interest' test upon unjustified beliefs about the motives of Chinese investments, a failure to fully appreciate commercial benefits of Chinese investments or personal predilections of the Treasurer.

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<sup>74</sup> The relevant size of an investment when it acquires shares in a corporation or the purchase of a business where the total assets exceed A\$50 million (*Foreign Acquisitions and Takeovers Act 1975 (Cth)* s 18). A person must also provide notice to the Treasurer indicating its intention to acquire Australian shares if that person proposes to enter an agreement under which it will acquire 15% or more of the voting power or issued shares in an Australian corporation or, either alone or together with an associate, or a corporation in which 40% or more of the voting power or issued shares are controlled by two or more foreign corporations or natural persons not ordinarily resident in Australia, either alone or together with associates (*Foreign Acquisitions and Takeovers Act 1975 (Cth)* ss 6, 9, 26(1)(c)).

<sup>75</sup> *Foreign Acquisitions and Takeovers Act 1975 (Cth)* s 26.

<sup>76</sup> *Ibid* s 18(4). The Foreign Investment Review Board, a non-statutory organisation, provides foreign investment policy advice to the Australian Federal Government on how to execute the policy, particularly whether or not an investment proposal is in Australia's national interest.

<sup>77</sup> *Foreign Acquisitions and Takeovers Act 1975 (Cth)* s 18(4).

Political point-scoring is the most likely inappropriate ground. There have been suggestions that the then Treasurer, Peter Costello, blocked Shell's attempted takeover of Woodside in 2001, in part, in order to obtain prestige in an election year. For example, as Dave Poddar implied:<sup>78</sup>

The Treasurer's decision must be considered in a political context. A Federal election [was] to be held by the end of 2001 and the Shell bid was very high profile and attracted significant publicity and comment from political leaders of all parties.

While not using the term, Chinese investors have become increasingly concerned that their investment proposals may often be rejected upon inappropriate grounds. A 2005 Chinese Government Report titled *Foreign Markets Access Report* 'considered that the "Australian National Interests" criterion is enabling excessive discretionary power, and certain examination and approval procedures are short of transparency, which have impeded the access of foreign capital into Australia'.<sup>79</sup> Chinese concerns appear to be growing as the country seeks access to Australian resources. For example, during his recent visit to China, Prime Minister Kevin Rudd was driven to assure Premier Wen Jai Bao that Australia's investment laws are not aimed at Chinese interests and are not in response to the Chinalco-Rio deal.<sup>80</sup>

Australian companies seeking such investments are also concerned that unreviewable decisions are being made on inappropriate grounds. For example, as David Crowe recently reported:

Company executives have accused the federal government of a damaging lack of transparency in its approach to foreign capital amid fears that Treasurer Wayne Swan is acting too slowly to approve major Chinese investments. Resource companies expressed frustration that the Foreign Investment Review Board was operating like a 'black hole' that left shareholders in the dark over whether deals were being considered ... Cape Lambert Iron Ore executive chairman Ian Burston said there was so little transparency in the FIRB process that he felt 'covered in soot' after waiting for approval of an investment.<sup>81</sup>

Considering the likely increase in the volume of Chinese investment proposals, the Treasurer will come under increasing pressure from Chinese investors and Australian companies seeking Chinese investment to administer the 'national interest' test in a consistent and transparent way and to not consider inappropriate grounds.

Absent government-led reforms, the Australian courts may be able to help ensure consistency through administering a procedural or substantive review of the Treasurer's decisions. This is the primary role of judicial review. As stated by Lord Diplock in *Council of Civil Service Unions v Minister for the Civil Service (GCHQ Case)* [1985]: 'Judicial review ... provides the means by which judicial control of administrative action is exercised'.<sup>82</sup> Wade and

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<sup>78</sup> Dave Poddar, 'Buy Australian? Australian Competition Law Relating to the Resources Industry in a Global Context' (22–25 August 2001) 25 *Annual Conference of Australian Mining and Petroleum Law Association* [21].

<sup>79</sup> 'Foreign Market Access Report' (2005) *Ministry of Commerce, People's Republic of China* [33].

<sup>80</sup> Burrell, n 61, at 2.

<sup>81</sup> David Crowe 'The Black Hole of National Interest', *Australian Financial Review*, 30 April 2008, p 10.

<sup>82</sup> AC 374 at 408.

Forsyth define administrative law as ‘the law relating to the control of governmental power’, and argue that its purpose is to keep the powers of government within their ‘legal bounds’.<sup>83</sup>

Unfortunately, the Treasurer will maintain the ability to consider inappropriate grounds because, as will now be demonstrated, the weight of the relevant case law suggests that the Treasurer’s decision on whether an investment proposal is in Australia’s national interest is almost unreviewable.

#### **d. Limiting the Treasurer’s Discretion by Insisting on Compliance with Policy**

The Treasurer’s decisions under the *Acquisitions Act* cannot be challenged under either the *Administrative Decisions (Judicial Review) Act 1977 (Cth) (ADJR Act)*<sup>84</sup> or the *Administrative Appeals Tribunal Act 1975 (Cth)*.<sup>85</sup> The Australian courts can therefore only review the Treasurer’s decisions on common law procedural grounds.

The main grounds for review at common law are breach of the rules of natural justice, *ultra vires*, jurisdictional error, error of law on the face of the record and failure to perform a duty.<sup>86</sup> Each of these grounds relate to whether the body exercising the power to make a decision conformed to considerations and procedures for the exercise of the power and did not go beyond the ambit of the power. So, review of the Treasurer’s decision under the *Acquisitions Act* may be possible if he or she failed to draw upon the relevant considerations or ignored procedures required for the exercise of that power, usually contained in government policy.<sup>87</sup>

The first issue then, is to determine the considerations and procedures (considerations) which the Treasurer may use in coming to a conclusion about the national interest. Such considerations are not contained in the *Acquisitions Act* so, under the *Acts Interpretation Act 1901 (Cth)*, it is appropriate to examine relevant extrinsic materials, such as explanatory memoranda and the relevant bills’ second reading speeches.<sup>88</sup> However, the case law demonstrates that this material gives the Treasurer so many issues to consider in a ‘flexible’ way that the courts are reluctant to engage in procedural review by insisting on strict compliance with the considerations.

When introducing the *Companies (Foreign Takeovers) Act 1972 (Cth)* to the Australian Parliament, the then Minister for Tourism and Recreation and Minister assisting the

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<sup>83</sup> H W R Wade and C F Forsyth, *Administrative Law* (8th ed, 2000) [4].

<sup>84</sup> In para H of sch 1 of the *ADJR Act*, decisions under the *Acquisitions Act* are included within the classes of decisions to which the *ADJR Act* does not extend. Accordingly, decisions under the *Acquisitions Act* are not reviewable under this legislation. Refer to judgement of Hill J in *Canwest Global Communications Corp v Australian Broadcasting Authority and the Treasurer for Commonwealth* (1998) ALD 877 [341].

<sup>85</sup> The *Acquisitions Act* does not provide that decisions under the Act are reviewable by the Administrative Appeals Tribunal.

<sup>86</sup> However, it should be noted that the distinction between *ultra vires* and jurisdictional error seems to have been largely dispensed with since the decision in *Anisminic Ltd v Foreign Compensation Commission* [1969] 2 AC 147 and so, for the purposes of this enquiry, *ultra vires* and jurisdictional error can be considered interchangeably.

<sup>87</sup> *Project Blue Sky Inc v Australian Broadcasting Authority* (1998) 153 ALR 490 at 516–17; See *Health Insurance Commission v Grey* (2002) 120 FCR 470 at 505.

<sup>88</sup> *Acts Interpretation Act 1901 (Cth)* s 15AB(2).

Treasurer, the Hon Francis Stewart, stated that the considerations should be ‘flexible’ and then listed a large number of issues which the Treasurer could consider in determining Australia’s national interest.<sup>89</sup> Issues included whether the takeover would lead to economic benefits to Australia, would result in a business which could be expected to follow practices consistent with Australia’s interest in matters such as exports and imports, and whether the takeover would be consistent with the government’s objectives in relation to such matters as defence, the environment and conservation, open and regional development and the preservation of Aboriginal land rights.<sup>90</sup> In addition to these considerations, Mr Stewart stated that ‘due weight’ would be given to the extent of the Australian participation in ownership, control and management that would remain after the takeover; and the interests of employees, shareholders and creditors of the business subject to the takeover proposal.<sup>91</sup>

Through almost identical wording with Mr Stewart’s considerations, subsequent explanatory memoranda have helped demonstrate parliament’s intention that the Treasurer’s discretion be wide and ‘flexible’. For example, Mr Stewart’s considerations were almost perfectly duplicated by those put forward by Prime Minister McMahon in respect of the former *Companies (Foreign Takeovers) Act 1975* (Cth) and then Federal Treasurer, the Hon Frank Crean MP, in an attachment to the explanatory memorandum which accompanied the *Foreign Takeovers Bill 1975* (Cth).<sup>92</sup>

The considerations have also expanded through government policy. For example, on 20 December 1983, Australia’s then Treasurer, the Hon Paul Keating MP, added the following to the considerations:

The extent to which commercial opportunities are provided for Australian contractors and consultants to participate in any construction work;

The contribution a proposal would make to the improved utilisation of resources, or the expansion of productive capacity arising from the introduction and diffusion of new technology and skills; and benefits and costs to Australia of any export franchise limitations.<sup>93</sup>

Furthermore, on 17 February 2008, the government published principles forming the basis of a ‘national interest’ assessment which are only relevant to direct investments by Sovereign Wealth Funds and foreign government bodies.<sup>94</sup> In determining the national interest, the government will consider whether the prospective foreign investor operates at arm’s length from the relevant government, adheres to the law, observes common standards of business behaviour, will hinder competition, will impact on Australian Government revenue or other policies, will affect Australia’s ability to protect its strategic and security interests, as well as considering the concerns of Australia’s economy and the broader community.

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<sup>89</sup> House of Representatives, Parliament of Australia, ‘Parliamentary Debates’ (1972) 140 *Commonwealth Parliament* 2743.

<sup>90</sup> *Ibid.*

<sup>91</sup> House of Representatives, Parliament of Australia, ‘Parliamentary Debates’ (1975) 95 *Commonwealth Parliament* 2677–9.

<sup>92</sup> *Ibid* at 2532–9.

<sup>93</sup> Hon Paul Keating, MP, Treasurer, ‘Review of Foreign Investment Policy’ (statement, 20 December 1983).

<sup>94</sup> Hon Wayne Swan ‘Government Improves Transparency of Foreign Investment Screening Process’ (17 February 2008) media release, Office of Treasurer of the Commonwealth of Australia [9].

So, it appears that the Treasurer has considerations which he or she is bound to follow. However, because these considerations are so numerous, varied and must be considered in a 'flexible' way, the court is reluctant to review the Treasurer's decision on procedural grounds. For example, in the decision of *Wight v The Honourable Chris Pearce, MP, Parliamentary Secretary to the Treasurer*,<sup>95</sup> Besanko J stated: 'A court will be slow to interfere with the Minister's decision as to what is in the national interests on the ground that a matter not taken into account was relevant to the national interest or a matter taken into account was irrelevant to the national interest'.<sup>96</sup>

However, the courts are also bound by weighty authority which directs the judiciary to insist that the executive exercise statutory discretion, including decisions over what constitutes national interest, in conformity with government policy. For example, in *Murphyores Inc Pty Ltd v Commonwealth (Murphyores)*,<sup>97</sup> Mason J held that: 'The Courts, while claiming no authority in themselves to dictate the decision that ought to be made in the exercise of such a discretion in a given case, are yet in duty bound to declare invalid a purported exercise of the discretion where the proper limits have not been observed'.<sup>98</sup>

The courts have applied this 'duty' to national interest. For example, in *Salemi v MacKellar (No 2) (Salemi)*,<sup>99</sup> a case involving the power of the Minister for Immigration to deport prohibited immigrants under s 18 of the *Migration Act 1958* (Cth), Barwick CJ stated the following:

If [the Government administrator] has any discretion to refuse to exercise the power to deport a prohibited immigrant while he remains a prohibited immigrant [on 'national interest' grounds], that discretion must be exercised in conformity with relevant Government policy.<sup>100</sup>

The court resolves the tension between its reluctance to review (from *Wight*) with a duty to review (from *Murphyores* and *Salemi*) by ostensibly only limiting the Treasurer's discretion on procedural grounds of 'Wednesbury unreasonableness', as examined now.

#### **e. Resolving the Tension: Wednesbury Unreasonableness**

In *CanWest Global Communications Corporation v Treasurer of the Commonwealth of Australia (Canwest)*, Hill J stated that the exercise by the Treasurer of his or her 'natural interest' powers was not totally immune from judicial review. A decision could be reviewed if the Treasurer had not satisfied any conditions precedent to making his or her decision; or if the Treasurer, in forming an opinion about the national interest, took into account a matter

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<sup>95</sup> [2007] FCA 26.

<sup>96</sup> *Ibid*, Besanko J at [120]. See also *Leisure & Entertainment Pty Ltd v Willis* (1996) 64 FCR 205 at 220; *CanWest Global Communications Corporation v Treasurer of the Commonwealth of Australia* [1997] 147 ALR 509 at 525.

<sup>97</sup> (1976) 136 CLR 1; adopting the reasoning of Kitto J in *R v Anderson; ex parte Ipec-Air Pty Ltd* (1965) 113 CLR 177 at 197-9.

<sup>98</sup> (1976) 136 CLR 1 at 199.

<sup>99</sup> (1977) 137 CLR 396.

<sup>100</sup> *Salemi v MacKellar (No 2)* (1977) 137 CLR 396 at 402-3 per Barwick CJ.

that was clearly irrelevant to the national interest or made a decision which no reasonable person in the Treasurer's position would have made.<sup>101</sup>

Furthermore, in *Leisure & Entertainment Pty Ltd v Ralph Willis (Leisure & Entertainment)*<sup>102</sup> it was held that 'the only basis, in my opinion, on which [the Treasurer's decision on the 'national interest'] might be impugned (and then only by a person having standing to do so) would be if it were shown that the opinion were not genuinely entertained or that the opinion was wholly unreasonable, by which I mean unreasonable in the "Wednesbury" sense'.<sup>103</sup>

However, the courts' willingness to review the Treasurer's decision on Wednesbury grounds is largely illusory. The courts are reluctant to review a decision on the grounds of Wednesbury unreasonableness, regarding it as very confined in its scope because it invites interference with the merits of administrative decisions.<sup>104</sup> For example, Lord Diplock stated that for a decision to be impugned on this ground, it must be 'so outrageous in its defiance of logic or of accepted moral standards that no sensible person who had applied his or her mind to the question to be decided could have arrived at it'.<sup>105</sup> The test is similarly narrow in most Australian jurisdictions, requiring the decision to be devoid of any plausible justification.<sup>106</sup>

Even aside from the court's natural reluctance to support a claim on Wednesbury unreasonableness, a review is also unlikely to succeed because of the judiciary's view that the 'national interest' power is sacrosanct. For example, in *Salemi*, Barwick CJ stated: 'We are dealing with the exercise of a fundamental national power exercisable according to Government policy for which ultimately there is responsibility to the Parliament'.<sup>107</sup>

As a result, the courts have a long history of reluctance to review the executive's decision of the national interest. For example, in considering the national interest in the context of the English Mining Industry Act 1926, Sankey J stated:

The question whether a particular thing is in the national interest is a question of the times, and it is a question of fact. This question is more fitting for the High Court of Parliament and for the High Court of Justice, after all what is a national interest is rather a question of policy to be pursued by Parliament from time to time than a question for legal decision, and, as above pointed out, a court is likely to be embarrassed when considering the topic of this sort.<sup>108</sup>

Australian courts have taken the same view. For example, in *CanWest*,<sup>109</sup> Hill J concluded that any court should be loathe to interfere with a discretion vested in the Treasurer on a

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<sup>101</sup> *Supra* n 96 per Hill J at 392.

<sup>102</sup> *Supra* n 96.

<sup>103</sup> *Ibid* at 221.

<sup>104</sup> *Minister for Aboriginal Affairs v Peko-Wallsend Ltd* (1986) 162 CLR 24 at 42 per Mason J; *Friends of Hinchinbrook Society Inc v Minister for the Environment* (1997) 69 FCR 28 per Sackville J (aff'd: *Friends of Hinchinbrook Society Inc v Minister for the Environment* (1997) 77 FCR 153).

<sup>105</sup> *GCHQ Case*, *supra* n 82, at 410.

<sup>106</sup> *Prasad v Minister for Immigration and Ethnic Affairs* (1985) 65 ALR 549 at 561 per Wilcox J; *Dornan v Riordan* (1989) 19 ALD 185 at 188 per Wilcox J; *Wouters, Wright and Holmes v DCT (NSW)* (1988) 84 ALR 577 at 584 per Bowen CJ, Wilcox and Lee JJ.

<sup>107</sup> *Supra* n 100, at 403.

<sup>108</sup> *Re Application of Amalgamated Anthracite Collieries Ltd* [1927] 43 TL 672 at 673.

<sup>109</sup> *Supra* n 96.

matter such as the national interest.<sup>110</sup> Furthermore, in *Leisure & Entertainment*, Spender J stated that ‘the ambit of the power conferred on the Treasurer is very wide’.<sup>111</sup>

So, while the courts maintain their authority to engage in procedural review over whether the Treasurer exceeded his or her power in coming to a decision about national interest, they will only do so if it can be established that the Treasurer has come to an opinion which is ‘wholly unreasonable’ in the ‘Wednesbury sense’. As a result, the court is unlikely to perform the type of procedural review which would force the Treasurer to come to his or her decisions in a consistent manner.

#### **f. Conclusion: the ‘National Interest’ Process Will Continue to Frustrate Chinese Investors**

Without the possibility of judicial review, there is no real mechanism for ensuring procedural consistency and that the Treasurer’s decision making is not based on inappropriate grounds. Therefore, much of the foreign investors’ current frustration with the process of the Treasurer’s determination over the ‘national interest’ is likely to remain and possibly intensify as Chinese investment grows and the Treasurer retains the discretion to refuse Chinese investment proposals on inappropriate grounds.

Some Chinese investors already suspect that the Treasurer is deciding investment proposals on inappropriate grounds. For example, Ian McCubbin, a Melbourne partner at law firm Deacons, who is managing a number of Foreign Investment Review Board applications, said some Chinese companies were withdrawing their investment applications believing they were unwelcome. He has said: ‘I’ve had very senior people in Beijing tell me “the Australian Government has banned investment by China in Australia” ... I also understand that there are at least two investments by Chinese enterprises or bodies in Australia who have dropped their investment proposals on the basis that they believe those investments would not be approved’.<sup>112</sup>

Tension over this test is likely to intensify in the future if amendments to the test and associated policy do not occur. Such tension will feed into the wider disagreement over Chinese efforts to seek agreement over investments and Australia’s insistence in continuing to use the case-by-case approach when applying the ‘national interest’ test.

### **ii. The Takeovers Panel**

#### **g. A New Experience: Blocking Chinese Takeovers**

The Takeovers Panel (the Panel) is the primary forum for resolving disputes about a takeover bid which arise during the bid period.<sup>113</sup> The Panel can make a declaration of unacceptable circumstances if it determines that a takeover either involves a contravention of a certain provision of the *Corporations Act 2001* (Cth) (*Corporations Act*) or unacceptably affects the

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<sup>110</sup> *Ibid* at 525; citing *Leisure & Entertainment*, *supra* n 96, at 220.

<sup>111</sup> *Leisure & Entertainment*, *supra* n 96, at 214.

<sup>112</sup> John Gournaut, ‘Chinese Feel Not Welcome in Australia’: see <<http://www.business.smh.com.au/business/chinese-feel-not-welcome-in-australia-20080428-294f.html>> as at 29 April 2008.

<sup>113</sup> *Corporations Act 2001* (Cth) ss 602, 657A, 659AA.

control of a company or the acquisition of a substantial interest in a company, having regards to certain principles.<sup>114</sup>

The Panel confronted Chinese state capitalism through the case of *Mt Gibson Iron Ltd (Mt Gibson)*,<sup>115</sup> which involved an attempt by China's fourth-largest steel group, Beijing Shougang Group, to buy a 19.7% stake in Mount Gibson from Russian trader and iron ore miner, Gazmetall.

The Panel blocked the sale because it found Shougang was associated with another Chinese group, APAC Resources Ltd, which has a 20% stake in Mount Gibson. The deal would have meant that, through its association with APAC, Shougang would have effectively gained control of the company without making the full takeover offer which is required when associated firms move to own more than 19.9% of a company.<sup>116</sup> The Panel's decision marked the first time Chinese investors have been censured by the Panel for their trading of shares.<sup>117</sup>

#### **h. Relevant Issue: Associations Between Chinese Companies**

The most important issue in *Mt Gibson* was that of 'associate' relationships, particularly those between the directors, executives and advisers of Shougang entities and APAC. John Gournaut said: 'Mount Gibson submitted that Shougang and APAC had a common goal of securing [an] off take [agreement for the supply of iron ore], which was only achievable by them acting together to control Mount Gibson'.<sup>118</sup>

Section 12 of the *Corporations Act* sets out the relevant tests of association. There are three tests, of which two are relevant here.<sup>119</sup> First, B is an associate of A if (and only if) B is a person with whom A has, or proposes to enter into, a relevant agreement for the purpose of controlling or influencing the composition of a company's board or conduct of its affairs.<sup>120</sup> This provision treats as owners those who can control a board or the affairs of the company by making agreements with the actual owners of the shares: 'Those who manipulate the strings are to be regarded as the personification of the puppet'.<sup>121</sup>

Second, B is an associate of A if (and only if) B is a person with whom A is acting or proposing to act in concert in relation to the company's affairs.<sup>122</sup> Again, this provision means

<sup>114</sup> *Ibid* s 657A(2)(a). The relevant principles are contained in s 602(a). These are that takeovers must take place in an efficient, competitive and informed market. The Panel should also ensure that shareholders and directors of the company must know the identity of any person who proposes to acquire a substantial interest in the company (s 602(b)(1)); that shareholders and directors of the company have a reasonable time to consider the proposal (s 602(b)(ii)); that shareholders and directors of the company are given enough information to enable them to assess the merits of the proposal (s 602(b)(iii)); and that shareholders all have a reasonable and equal opportunity to participate in any benefits accruing to shareholders through any takeover proposal (s 602(c)).

<sup>115</sup> (2008) ATP 4.

<sup>116</sup> *Corporations Act 2001* (Cth) s 606.

<sup>117</sup> 'Shougang Bid on Ore Producer Foiled', *China Daily*, 2 April 2008, p 1.

<sup>118</sup> *Supra* n 112, at [49].

<sup>119</sup> *Corporations Act 2001* (Cth) s 12(2)(a) states a bidder or holder is a body corporate, its associates include a body corporate that it controls, a body that controls it and a body corporate that is controlled by an entity that controls it.

<sup>120</sup> *Ibid* s 12(2)(b).

<sup>121</sup> *Afro-West Mining Ltd v Australian Mining Investments Ltd* (1988) 14 ACLR 709 at [51].

<sup>122</sup> *Corporations Act 2001* (Cth) s 12(2)(c).

that ‘associated’ parties must have an understanding as to some common purpose or object and ‘not simply two persons separately and coincidentally acting in the same manner’.<sup>123</sup>

The relevant issue here is the ability of the Panel to perform forensic enquiries into the relationships between potential Chinese investors. The Panel openly admits its inability to perform detailed enquiries into associate relationships, stating in *Dromana Estate Limited OIR*:

Determining associations must depend on the facts of the case, and this will often require analysis of complex circumstances. Moreover, the Panel recognises that issues of association are notoriously difficult for outsiders to prove since access to the type of evidence needed is rarely available. Issues of association frequently need to be decided on the basis of inferences from partial evidence, patterns of behaviour and a lack of a commercially viable explanation for the impugned circumstances.<sup>124</sup>

Such reasoning has manifested in a number of the Panel’s decisions. For example, in *Re Winepros Ltd*,<sup>125</sup> the Panel refused to make a declaration of unacceptable circumstances because, in its view, it had insufficient means to investigate the allegations. Furthermore, in *Re Rivkin Financial Services Ltd*<sup>126</sup> the Panel decided not to conduct proceedings where it was alleged that effective control of a company had passed to parties which had a pre-existing associate relationship because the evidence was insufficient to support inferences to that effect.

The Panel will find it increasingly difficult to use its limited powers to ascertain relationships of association when considering Chinese investments due to the close but often unclear relationship between the Chinese Government and commercial entities. The Chinese Government owns most companies, which means that most enterprises are already loosely ‘associated’ through a common owner. For example, only 40 of the over 1500 firms which are listed on the Shanghai Stock Exchange are private.<sup>127</sup>

The high level of state ownership of Chinese entities manifests in two problems for the Panel. First, even if the two or more potential Chinese investors appear to have acted separately, rather than as associates, it will be very difficult for the Panel to conclusively determine whether or not the state has been involved in coordinating a deal between the two parties, considering the Chinese Government is likely to be a common owner, or at least major stakeholder, of both parties.

Second, even if the state-owned companies are not considered associates through common ownership, the Panel may be required to consider whether the relevant takeover deal has been coordinated as part of a wider state program, such as the ‘Go Abroad’ policy. Such coordination is already very common, particularly through the National Development and Reform Commission, a macroeconomic management agency under the Chinese State Council, which has broad administrative and planning control over the Chinese economy. As the *Weekend Australian Financial Review* recently commented:

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<sup>123</sup> *Supra* n 115; *Adsteam Building Industries v Qld Cement* [1985] 1 Qd R 11.

<sup>124</sup> [2006] ATP 8 at [25].

<sup>125</sup> (2002) 43 ACSR 566.

<sup>126</sup> (2004) 50 ACSR 147.

<sup>127</sup> Lee, n 70, at 28.

The so-called ‘Go Abroad’ policy in China shows strong state control over the foreign ambitions of domestic steel makers. And its National Development and Reform Commission has laid down guidelines for the type and scale of overseas investments the Government is prepared to bankroll. It is the NDRC’s job to approve applications in overseas projects and companies and to ensure that Chinese companies are not played off against each other. It is up to the individual company to submit investment plans, but the NDRC is very hands-on in its approvals process.<sup>128</sup>

As Chairman of Gindalbie Metals, George Jones, who was summoned to Beijing to meet National Development and Reform Commission (NDRC) officials in 2007, recently stated: ‘The NDRC vets things carefully ... they set the policies [behind Chinese companies’ investments]’.<sup>129</sup>

Other Chinese bodies are also involved in coordinating investments between Chinese companies. For example, the state-owned Assets Supervision and Administration Commission was formed in 2003, and is charged with managing the 150 biggest state-owned businesses to ensure they respond to government priorities and plans.<sup>130</sup>

While the Panel did not explore the issue of Chinese state control over APAC or Shougang in *Mt Gibson*, there were suggestions of the state’s role in driving investment. For example, information before the Panel suggested that APAC invested in Mt Gibson:

... only for the purpose of becoming the first Chinese company which would have a major stake in the fastest developing company among all Australian iron ore companies. The intention was that by the time the governing Communist Party of China would issue a directive to invest in foreign iron ore companies, APAC Resources would have the advantage of being the first player on that market.<sup>131</sup>

Furthermore, the Panel concluded that the main motive for the two Chinese investors was to give effect to China’s ‘Go Abroad’ policy, albeit without using the term:

The panel infers that the parties were associated in relation to securing off-take [of iron ore] from Mt Gibson. The panel considers that the strategic importance of securing supply of iron ore in the current climate, particularly for Chinese companies experiencing high demand and rising raw material cost of their products, was a motive for them in the proposed transaction.<sup>132</sup>

#### **i. Conclusion: the Associate Test Will Continue to Cause Tension Between China and Australia**

The Panel is being asked to apply a test which it already struggles to administer to Chinese companies because the relationships between these companies, particularly through the state, are unclear. As Chinese takeover bids grow, the Panel will increasingly be put in this awkward position.

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<sup>128</sup> Ryan, n 52, at 25.

<sup>129</sup> *Ibid* at 25.

<sup>130</sup> *Ibid* at 25.

<sup>131</sup> *Supra* n 112, at [25].

<sup>132</sup> *Ibid* at [51].

In the future, Chinese companies may dispute the Panel's ability to make such inferences of government control over the direction of investment decisions. Alternatively, even if the broad assumption is correct, individual private Chinese companies may argue that they are already presumed to be state-owned or coordinated with their investment partner, and are therefore unfairly discriminated against by the Panel compared to their North American or European investment rivals. Either way, the Panel may come under heavy Chinese pressure in the future, increasing tension between and Australia and China over foreign investment.

### **lii. Sovereign Immunity**

Enforcing judgments against the Chinese sovereign wealth fund (CIC) as a shareholder in an Australian company will be challenging because doing so requires numerous political and diplomatic steps which, due to the vagaries of international politics, have little certainty of success.

### **j. Relevant Issue: Enforcing Judgment**

The issue of sovereign immunity is likely to only arise when China uses certain investment vehicles to effect an investment. If the vehicle is a locally incorporated entity then local law will apply. This is because, under the *Foreign States Immunities Act 1985* (Cth) (*Immunities Act*), a foreign company is amenable to the jurisdiction of local courts if it is 'present' within a jurisdiction.<sup>133</sup> By ensuring that foreign companies carrying on business within Australia are amenable to the jurisdiction, parliament seeks to impose substantially the same controls under the legislation as are placed on local companies.<sup>134</sup>

However, the challenge is far more complex in situations in which the CIC invests in an Australian business without seeking to own it outright and judgment needs to be taken against this entity as a shareholder. If an order is made against an Australian company, it may be difficult to enforce judgments against the CIC as a shareholder because doing so involves enforcing judgments from one sovereign justification, Australia, against another, China.

Such challenges have already been mapped out in the case of sovereign debt.<sup>135</sup> There are no clear legal principles or formal structures to guide the recovery of sovereign debt, leaving much to the discretion and relative bargaining positions of the parties.<sup>136</sup> J F Hornbeck wrote of the challenges involved in enforcing judgments against sovereign entities in these circumstances:

In such instances, enforcement is difficult and/or impossible. Countries in default tend to reach a voluntary agreement with creditors or risk costly, prolonged litigation and ostracization [sic] from financial markets. Litigation is the least preferred method given that recovering sovereign assets is nearly impossible. There are no formal rule books on how to proceed, but all parties are best served by avoiding a protracted and confrontational

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<sup>133</sup> *Foreign States Immunities Act 1985* (Cth) s 10.

<sup>134</sup> This principle was referred to by Ackner LJ, speaking of equivalent United Kingdom provisions, in *South India Shipping Corp Ltd v Export-Import Bank of Korea* [1985] BCLC 163 at 168.

<sup>135</sup> Sovereign debt is accumulated through a variety of matters including such debt as can be borrowed from another sovereign, an international organisation or a foreign private equity. See, for example, Y Francisca Pei – Fei Wong, 'Towards an Ethical Framework for Sovereign Debts — A Look into the Doctrine of "Odious Debts"' (24 April 2007), LLM Thesis, University of California, Berkeley, 24.

<sup>136</sup> *Ibid* at 25.

negotiation. Negotiations may take the form of formal meetings between creditor committees and government groups, less formal consultation agreements, or some combination.<sup>137</sup>

Argentina provides a useful example. In December 2001, after four years of deepening recession and mounting social unrest, Argentina's government collapsed and ceased all debt payments. Argentina had failed to pay before, but this time it registered the largest sovereign default in history. The Argentinean government owed US\$195.5 billion in bonds and loans.<sup>138</sup> Only after three years of wrangling did Argentina make a 'final' offer which required investors to write off around 75% of the debt.<sup>139</sup>

Without resort to local law, Australian companies can only attempt to enforce a judgement against the CIC (as a shareholder) through agreement with the Chinese Government, as required under the *Immunities Act*. This Act states that judgments can only be made in accordance with an agreement with that state<sup>140</sup> or through diplomatic channels.<sup>141</sup>

There are two main problems with this process. First, using the path outlined by the *Immunities Act* means that politics, particularly state-to-state diplomacy, is required to enforce a commercial agreement. The Australian Government may be reluctant to help a company enforce a debt upon China due to the political climate of the day.<sup>142</sup> Tension over any other issue, such as alleged human rights abuses in China, may mean that the government refuses to further inflame the relationship by enforcing judgment against a Chinese entity.

Second, the procedure is costly and time consuming. The initiating application must be delivered to the Attorney-General for transmission to the relevant department of a foreign state by the Department of Foreign Affairs and Trade.<sup>143</sup> The application must be accompanied by a request for service of the originating process, the proper plaintiff's statutory declaration that laws and rules with respect to service outside the jurisdiction of the court are complied with, and a certified translation of the initiating process into an official language of the foreign state where that language is not English.<sup>144</sup>

Such a process is particularly onerous when applied to a default judgment, traditionally a process whereby a party seeks quick and cheap conclusion to a proceeding. There may be no default judgement against a foreign state unless it is proved that service of the initiating process was effected in accordance with the *Immunities Act*, that the time for appearance is expired, and that the court is satisfied that the foreign state is not immune in a particular proceedings.<sup>145</sup>

#### **k. Conclusion: Limited Utility for Chinese State Capitalism**

The rise of Chinese state capitalism and the increasing complexity which heavy government involvement may bring to commercial transactions suggests that review of the procedural and

<sup>137</sup> J F Hornbeck, 'Argentina's Sovereign Debt Restructuring', CRS Report for Congress, 19 October 2004, at <<http://www.fpc.state.gov/documents/organization/39301.pdf>> at CRS-5.

<sup>138</sup> *Ibid* at CRS-1.

<sup>139</sup> *Ibid* at CRS-9.

<sup>140</sup> *Foreign States Immunities Act 1985* (Cth) s 23.

<sup>141</sup> *Ibid* s 24(1).

<sup>142</sup> See Hornbeck, *supra* n 137, at CRS-15.

<sup>143</sup> *Foreign States Immunities Act 1985* (Cth) s 24(4).

<sup>144</sup> *Ibid* s 24(2)(a)–(c).

<sup>145</sup> *Ibid* s 27(1)(a), (b).

substantive provisions of the *Immunities Act* may be required to avoid political wrangling and ensure that judgment can be effective. Australian companies may be inhibited from various strategies or from obtaining fresh capital if it appears that there would be difficulties in enforcing judgments against some of its shareholders, in this case, the Chinese sovereign wealth fund. Such challenges may inhibit growth of Australian companies, impede investment opportunities and create diplomatic issues between the Australian and Chinese Governments.

## **29. Moving Forward**

As has been demonstrated, Chinese investment invokes a range of issues for Australian foreign investment systems. Such investment is likely to grow in the future and thus put more rather than less strain on the foreign investment system. The danger is that such strain may lead to fear-driven protectionist legal reform.

Australia appears to have a more positive view towards China than our trading neighbours. For example, in October 2007, Sydney University's United States Studies Centre showed 56% of Australians held a favourable opinion of China, and a Lowy Institute Poll around the same time showed a similar result.<sup>146</sup> Allan Gyngell, Executive Director of the Lowy Institute concluded: '[T]o Australians, China represents an opportunity not a threat'.<sup>147</sup> Such a view compares very favourably to other countries. For example, in June 2007, the Pew Research Centre's Global Attitudes Project found just 42% of Americans hold a 'favourable' view of China, along with 49% in Britain, 34% in Germany and 27% in Italy.<sup>148</sup>

Australia needs to maximise this positive sentiment and explore how the foreign investment system must be adjusted for Chinese investment in the future, if at all, using the following steps. First, all parties involved need to understand that they both benefit from foreign investment in Australian companies, particularly those in the resources sector. Such research should also explore how and why foreign investment can be beneficial to resource companies of different sizes in different ways and thus will help Australia come to a consensus on Chinese investment.

Second, more research is required into Chinese state capitalism and the extent of its reach in Australia, in order to ensure debate occurs on grounds of reason, rather than public hysteria. Existing fears may already be overstated, as suggested by the Chairman of Gindalbie Metals, George Jones:

Chinese investments to date are less than a quarter of those made by British, American and Japanese companies ... [China] would have to spend something like \$50 billion before the Chinese came anywhere near the level of investment that Japan or the US have in Australia.<sup>149</sup>

Third, dialogue should then be entered into with China to develop a mutually beneficial investment framework that is fair and commercially driven. Such a framework should include disclosure provisions in order to maintain public confidence in the process. As part of this disclosure regime, entities with a certain amount of government influence should publish

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<sup>146</sup> John Garnaut, 'China Investment Radar Hits Home', *Business Day*, 8 October 2007.

<sup>147</sup> *Ibid* at 1.

<sup>148</sup> *Ibid*.

<sup>149</sup> Andrew Burrell, n 60, at 16.

information dealing with the rights of shareholders, key ownership functions, the flow of information between management and the governing board, and the composition and responsibilities of the board.

Finally, out of such understanding and mutual dialogue can come objective, sensible reform to the Pressure Points if indeed, by that stage, legal reform is still required. Such issues may have been adequately determined through earlier procedures.

### **30. Conclusion**

The power of financial deals to secure resources is here to stay. As reported in the *South China Morning Post*, a Chinese banker recently stated: ‘In the Middle Ages, you rolled an army in and took over natural resources. Now it’s done through the stock market’.<sup>150</sup> Through its enormous resources demands and foreign exchange reserves, China now has the motive and means to fund a large number of investments in Australia’s resources sector.

This paper is not a judgment on the merits of the rise of China as a power, trading partner, or the model of Chinese state capitalism. It is encouraging to see the Treasurer of Australia approve ‘the proposal by the Aluminium Corporation of China Limited (Chinalco) to acquire up to 14.99% of the shares in Rio Tinto Plc, the London Stock Exchange listed arm of Rio Tinto Group [on 24 August 2008]’.<sup>151</sup>

However, Australia should engage in research and public debate about the rise of Chinese state capitalism. Informed debate is more likely to lead to the sort of practical, targeted outcomes which Australia requires to move forward in a constructive fashion. Furthermore, a better-educated public may be less susceptible to protectionist sentiment.

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<sup>150</sup> T Lee Master, ‘Shougang Scraps Mount Gibson Bid’, *South China Morning Post*, 2 April 2008, p. 4 .

<sup>151</sup> Press release No. 094 of the Treasurer.

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# THE ARBITRATION OF CELEBRITY DOMAIN NAME DISPUTES

The Honourable Neil Brown QC\*

## Abstract

The cult of celebrity and the arbitration of internet domain name disputes bring together two vibrant features of the modern age. Inevitably, celebrities' names are in demand by those who want to trade on them commercially, by those who want to adulate or denigrate celebrities, and by the celebrities themselves.

This article describes the fast-track and compulsory arbitration process, known as the Uniform Domain Name Dispute Resolution Policy, or UDRP (the 'policy') that is open to celebrities to claim back a domain name alleged to have been registered improperly. The policy explains that the celebrity must show a trademark in the personal name at issue and how to prove a common law trademark if it is not registered.

The claimant must then prove the three elements of a UDRP claim: that the domain name is the same as or confusingly similar to the trademark; that the registrant of the domain name has no right or legitimate interest in it; and that it was registered and used in bad faith.

Although both an ultra-modern problem and solution, cases will not succeed without compliance with a time-honoured principle: cases under the UDRP will be won or lost depending on whether the parties adduce evidence that really proves their case.

## 31. 1. The Nature of Celebrity Domain Name Disputes

You would think that celebrities, being what they are, would be keen to register their names as domain names, set up their own websites and use the websites to promote themselves. Some do, but others seem to have been slow off the mark, only to find that someone else has got up earlier and in effect stolen their name, registered it as a domain name and used the domain name to set up an unauthorised website.

Of course, it can be worse than that: the domain name is sometimes linked directly to a pornography website or used as a bait to attract internet users who are then switched to a website selling anything from Viagra to Pacific cruises.<sup>1</sup> This, of course, can give the celebrity a bad name, or an even worse name than he or she previously had. Or he or she could just be made a figure of fun: see for instance the unfortunate events recounted in the *David Pecker Case*.<sup>2</sup>

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\* The Hon Neil Brown QC, FCI Arb, is an international and domestic arbitrator and mediator who practices in Australia and London. He is on several panels for the arbitration of domain name disputes in Europe, the United States, Asia and Australia, has arbitrated many disputes and has written and lectured on this subject. For more details visit <<http://www.neilbrownqc.com>>.

<sup>1</sup> See, as a recent example of this practice, *Nick Cannon v Nikolay Zuyev*, WIPO Case No D2007-0870.

<sup>2</sup> WIPO Case No D2006-1514.

There are other problems that arise in the case of celebrity domain names and they vary from case to case. They depend on the celebrity, how the celebrity's name came to be used as a domain name and how the domain name is being used. The party who registered the name will also invariably raise various defences or excuses to try to hold onto the name and defeat the celebrity's claim.

Let me give a few examples of the categories of problem that arise before we look in more detail at the issues that arise and how they have been resolved.

### **liii. Introduction to the Problem**

One of the early cases was *Madonna's Case*,<sup>3</sup> where <madonna.com><sup>4</sup> was registered by a cybersquatter and linked initially to a pornographic site. This is an early illustration of the problems celebrities face when domain names and websites make unauthorised use of their names. The celebrity does not have access to the domain name or the opportunity to use the domain name as he or she wants. Moreover, if the domain name is then linked to a pornography site, it undoubtedly disparages the celebrity's name, even where the respondent in *Madonna's Case* argued there was not much of a name to disparage. Madonna successfully had the domain name transferred to her. Similarly, in *Mick Jagger's Case*,<sup>5</sup> the domain name <mickjagger.com> was linked to a pornography site, enabling the panellist<sup>6</sup> to find in Mr Jagger's favour.

In other cases, it is not only the linking of the domain name to a pornography site that concerns the celebrity. Frankly, the fact that the celebrity misses out on money their domain name makes may be of equal or greater concern.

Recently, the Brazilian footballer Pelé had three domain names registered that incorporated his name without his permission.<sup>7</sup> All three of the domain names had been taken without his authority and associated his name with an activity which reflected adversely on him. These included pornography as well as advertising goods and services with the impression that he endorsed them. The latter activity is particularly pernicious, as it is not just money making at issue, but the fact Pelé was not making it.

Sometimes, unauthorised celebrity domain names are linked to websites to which the celebrity objects simply because of the content of the unauthorised website; for example, a particularly strident form of animal welfare or conservation. Celebrities generally do not like their names being associated with goods, services or causes that they do not approve of, or being used in a way they cannot control. Therefore, the following questions arise, which go to the substance of the issue with which we are concerned.

Do celebrities have a right to protection of their own name? What can they do to retrieve a domain name if they find it has been taken? Can they sue? Is there any other sort of claim they can bring? What do they have to prove? Will they win?

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<sup>3</sup> *Madonna Ciccone, p/k/a Madonna v Dan Parisi and 'Madonna.com'*, WIPO Case No D2000-0847.

<sup>4</sup> In this article, domain names are identified in this fashion as that is the way they are set out in decisions given by arbitrators or panellists under the UDRP Policy.

<sup>5</sup> *Mick Jagger v Denny Hammerton*, NAF Case No FA0007000095261.

<sup>6</sup> The arbitrators under the UDRP are known as 'panellists' as they are drawn from a panel or list of arbitrators maintained by each of the providers of dispute resolution services under the UDRP.

<sup>7</sup> *Glory Establishment v Futbolmasters Ltd*, WIPO Case No D2007-0439.

The same questions arise with respect to other unauthorised websites that are simply offensive and expose less salubrious aspects of the celebrities that they would rather remained secret. Other websites are just clingingly and embarrassingly sycophantic<sup>8</sup>. Then again, although some websites may be sycophantic, the celebrity, despite the disclaimer on the website, is clearly happy to be promoted in the way he or she is presented on the website and does nothing to stop it. For example, <www.algore.org> generously extols the virtues of the former Vice-President Gore. Other celebrity websites are fairly straightforward, like the English soccer player Wayne Rooney's site at <www.waynerooneyonline.com>, which is laudatory without being sycophantic. Likewise, a site put up by one of David Beckham's fans at <www.davidbeckham.ws><sup>9</sup> seems to be tolerated.

Sooner or later, however, money rears its ugly head and one comes across yet another case where a celebrity's name has been used to make money by pushing one blandishment or another. Thus, in *Morgan Freeman v Mighty LLC*,<sup>10</sup> Morgan Freeman's name was used in a domain name and linked to an entertainment site. Whilst apparently not pornographic, the website sold Viagra and a few other offerings. Still other celebrity domain names and the websites they lead to are what you might call 'normal' deception. The domain name incorporating the celebrity's name diverts internet users to a commercial website in the same area of interest as the celebrity whose name has been used, such as music in the *Rolling Stones Case*.<sup>11</sup>

This illustrates another problem, of course, which is how many domain names do you have to register and pay for, or lock up, to stop the unauthorised use of your name? Celebrities find that they retrieve one domain name and close down the corresponding website only to find that another has sprung up with a slightly different spelling. But all of these problem cases have the same major defect, which is that their contents cannot be controlled by the celebrity. Either they are dormant or unused domain names buried like unexploded bombs by the person who registered them. Sometimes a professional cybersquatter registers the name and waits for a potential new owner to buy the name.

So the essential question arises again: can the celebrity do anything about this? If the website is up and running and the full horror of its contents have been released on the public, can the celebrity really do anything about it?

## **32. 2. Solutions to the Problem of Celebrity Domain Name Disputes**

### **liv. Get in First**

One way for celebrities to avoid these problems is to register their own names and all conceivable variations of them first, before anyone steals them. So, as with other aspects of the internet, the best advice is to get in first.

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<sup>8</sup> See, as one of many examples, the eulogy in the unofficial website of the actor Gary Raymond at <<http://www.garyraymond.com>> describing him as 'divinely gifted'.

<sup>9</sup> 'WS' is the Internet country code for Western Samoa and is said to be valuable because some viewers think the letters stand for web site.

<sup>10</sup> WIPO Case No D2005-0263.

<sup>11</sup> *Musidor BV v Jung Hochul*, NAF Claim No FA0112000103053.

The problem with putting this advice into practice is that budding celebrities do not know that they are celebrities until the public or the media decree it. In the meantime camp followers, eccentrics, fanatics and cybersquatters who have followed the careers of their incipient heroes have already registered one or all of the domain names available in the celebrities' names. This is happening more frequently and faster as the time period in the public eye that is necessary to qualify as a celebrity becomes shorter and shorter. A moment of fame is now certainly less than Andy Warhol's suggested 15 minutes. It is, I suppose, the inevitable cyber age equivalent of enrolling your child some years in advance in an exclusive school or club.

Some celebrities are still too slow off the mark in registering domain names. This was evident when Britney Spears and Kevin Federline had their baby. A gossip columnist let it be known that the baby had been named Sutton Pierce Federline and the next day, only a week after the child was born, someone registered the domain name <suttonpiercefederline.com> and several other variants. The unfortunate thing is that the owners of the domain name have been earning income from their asset by linking it to a site that carries advertisements, depending on what the computer reads as being associated with or generic to the domain name. Consequently, <suttonpiercefederline.com> has sensed the 'pierce' part of the name and the website carries advertisements and links for body piercing. The irony was that the name used by the cybersquatter for the domain name turned out not to be the name given by the fond parents to their child. Tom Cruise and Katie Holmes are in a similar position, as they allowed through delay a domain name to be registered in the name of their daughter, Suri: <suricruise.com>.

The problem with registering the domain name ahead of the cybersquatter is the really determined and mischievous will register variations. For instance, instead of registering <madonna.com>, a cybersquatter will register <madonnatours.com>, <madonnafashions.com> or Madonna with one 'n' or two 'd's. There is literally no end to the possible combinations and permutations, as companies like Yahoo have found to their annoyance and cost. They are now forced to have great stables of domain names on which they pay the annual registration fees, but never use. Yahoo are obliged to hold these domain names just in case some inventive cybersquatter in Brazil concocts a new way of spelling 'Yahoo' in Portuguese and diverts their potential customers to the cybersquatter's own unauthorised website.

For celebrities who do not get in first and find their name has been registered as a domain name their only hope is to take action to have the domain name transferred to them.

#### **iv. Get a Consent Order**

Sometimes domain name holders will consent to the transfer of the domain name to the celebrity. They may wish to avoid a fight, realise they would lose the fight, or have no claim to the domain name. An example of this is *Carnival Plc v Dave Jackson*,<sup>12</sup> where the domain name at issue was <queen-elizabeth-2.com>. The complainant was a cruise ship company that had registered trademarks over the name 'Queen Elizabeth 2' in relation to various goods and services. The domain name was transferred to it by consent, because the registrant had lost interest in keeping the name and probably just did not want to put up a fight. Consent orders were made in a number of 2006 decisions such as *Norgren, Inc v Norgren, Inc c/o*

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<sup>12</sup> NAF Case No FA0997916.

*Domain Administrator*,<sup>13</sup> and *DinersClub International Ltd v Nokta Internet Technologies*.<sup>14</sup> Further, in 2007 a consent order was made in *Tom Stoppard, Tom Stoppard Limited v Texas International Property Associates*.<sup>15</sup> Clearly, it is sometimes worthwhile trying to have the domain name transferred by consent.

#### **lvi. Buy the Domain Name**

The first method some celebrities think of when they find an unauthorised person has registered their name as a domain name, is to buy the name from the registrant. This sometimes works, but the problem is that once they show interest in buying the domain name, the price goes up and they may have to pay an exorbitant price.<sup>16</sup> They might also find that they are, in effect, being held to ransom by a group or person who wants more than money to hand over the registration of the domain name.

This was the experience faced by Paul McCartney of The Beatles when he tried to retrieve a domain name in his own name. In *MPL Communications, Limited and MPL Communications, Inc v LOVEARTH.net*<sup>17</sup> the respondent who had registered his domain name told McCartney he had to adopt a letter that promoted a particularly extreme environmental political line, to have it transferred to him. McCartney refused to do this, took action to get the domain name back and succeeded. In that case, experienced panellist, Mr Peter Michaelson, made a good general statement on what celebrities should do when faced with this situation:

No obligation is imposed on a trademark owner to do any act, support any activity or endorse or affirm any cause for any respondent in order to retrieve a domain name from that respondent that should rightfully belong to that owner. To require otherwise would permit a respondent to effectively extort action of some nature from the celebrity — a result clearly in conflict with the Policy.<sup>[18]</sup> While the celebrity, in his (her) sole discretion, may decide, for whatever reason (s) he has, to acquiesce to or reach a negotiated settlement with a respondent in exchange for transfer of a corresponding domain name, the decision to do so lies solely with the celebrity. That respondent has absolutely no power, nor does the Policy permit any, to compel the celebrity to do any act — regardless of how trivial that act might appear to be — to obtain that domain name.

Other celebrities have found cybersquatters not only demand money, but an endorsement of a product, a telephone call or meeting under the guise of being a fan.

#### **lvii. Be Extorted**

Sometimes, the celebrity is forced to deal with someone who is not really a fan, but rather an opportunistic cybersquatter. It is particularly galling that the celebrity may end up paying a

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<sup>13</sup> NAF Case No FA0603000670051.

<sup>14</sup> NAF Case No FA0605000720824.

<sup>15</sup> WIPO Case No D2007-1404.

<sup>16</sup> At the time of writing, the domain name <dannielynnbirkhead.com>, reflecting the name of Anna Nicole Smith's child, is for sale on eBay for US\$1million, an asking price of course, but bids for it are up to US\$600,000.

<sup>17</sup> NAF Case No FA01097086.

<sup>18</sup> The UDRP Policy, which effectively governs disputes over domain names.

large sum of money to simply retrieve their domain name. However, sometimes skilled negotiation and a bit of flattery bring the domain name down to a reasonable price.

### **Iviii. Court Action**

If this cannot be done, the alternative is to sue, either for breach of trademark or passing off. The problem is the facts may not be strong enough to show the celebrity has a trademark which has been tarnished by the registered domain name. The facts may also not be strong enough to support an action for passing off. The defendant may not have tried to pass as a Madonna or Brad Pitt, but registered a domain name in the hope it becomes valuable. In a nutshell, the problem with court action is that sometimes it fails. Moreover, court actions are notoriously slow and expensive and they may simply not be an appropriate means of attempting to recover a domain name.

### **lix. Bring a Complaint Under the Uniform Domain Name Dispute Resolution Process**

The other solution-which is the subject of this article is to bring an application under the Uniform Domain Name Dispute Resolution Process (the UDRP). The celebrity can try to obtain an order for the registrar of the registered domain name to transfer their domain name back to them. The celebrity can then make the domain name an official website, link it to their official website or do nothing but pay the subscription for it. Alternatively, the celebrity may ask for and obtain an order that the domain name be cancelled. Of course, transfer is a more popular order than cancellation as the registrant may register the domain name as soon as it becomes free again.

The UDRP process is compulsory, quick, simple and cheap. This makes it probably the best course of action for celebrities who wish to transfer or cancel an unauthorised registration of their domain name.

The person who registered the domain name is compelled to be a respondent in the UDRP process because their registration of the domain name is a contract with a registrar accredited by the Internet Corporation for Assigned Names and Numbers (ICANN).<sup>19</sup> You cannot buy a domain name; the contract in effect enables you to lease it. That contract includes a clause to the effect that, if there is a challenge to your ownership<sup>20</sup> of the domain name, you agree to submit to a compulsory arbitration process,<sup>21</sup> using an arbitrator service accredited by ICANN. The two major bodies that provide those services are the World Intellectual Property Organisation (WIPO) in Geneva and the National Arbitration Forum (NAF) in the United States.

If the registrar does not put in its contracts the clause that makes UDRP compulsory, it may lose its ICANN accreditation and thereby its business. The same thing will happen if the registrar fails or refuses to implement an order to transfer or cancel a domain name. Therefore, anyone who registers a domain name remains subject to a possible claim by another who claims to have a greater interest in the domain name. If successful, there is a good chance that the order obtained will be carried out.

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<sup>19</sup> This is the company that runs the Internet.

<sup>20</sup> Actually, you do not own a domain name, but rather, you lease it.

<sup>21</sup> Called an administrative proceeding.

Thus, a celebrity is able to activate that process and bring a claim against the party who has registered the domain name. If successful, the celebrity will obtain an order to have the domain name transferred or cancelled. The process is quick because it is almost a form of strict liability and there are only a limited number of defences to such claims. Also, the agencies that provide the arbitration services and their appointed arbitrators are under strict time limits to complete the process promptly.

These arbitration services go to great lengths to ensure that the arbitration panellists are unbiased and there is neither the appearance nor an actual conflict of interest. The number of sustained and reasoned rejections of complaints and the dissenting decisions in three-person tribunal judgments indicates the panellists take their work very seriously and conscientiously.

The process is also comparatively cheap because it is provided for a set fee and costs cannot be ordered for or against either party. Apart from the filing and administrative fee, the only costs for bringing such an action are attorney's fees. However, celebrities and any parties to arbitration may choose not to engage an attorney. There are no oral hearings, interrogatories or discovery. Cases are decided on each side's written submissions with any additional submissions or material the panel requests.

The system has one drawback; the tribunal or panel hearing the case may only make an order to transfer the domain name to the successful complainant or order its cancellation. There is no power to make another order, grant an injunction, award damages, costs or interest. If the aggrieved party wants a remedy other than transfer or cancellation, he or she must sue in the courts. This, of course, gives rise to endless problems about jurisdiction, service and enforcement of the judgment. However, the UDRP procedure has the benefit of being quick, cheap and final in that the decision cannot be appealed.<sup>22</sup>

In summary, celebrities who are annoyed that someone has been using their name in a domain name can bring a quick arbitration application under the UDRP. They may thereby obtain an order, from which there is no appeal, that the domain name be transferred to them or cancelled. Of course, to bring a complaint under the UDRP process, it must be about domain names. The application must not be a guise or a device for a different cause of action such as breach of contract or trust.<sup>23</sup>

This article is about the UDRP process and contemplates many questions. Can a celebrity bring a claim under the UDRP process to claim back his or her own name? Does it matter whether a celebrities' name is being used to make money, exploit a fantasy, blackmail the celebrity or run a fan site? If such a claim can be brought, will the celebrity win? Finally, what do celebrities have to prove?

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<sup>22</sup> An unsuccessful respondent may, however, institute court proceedings to set aside the order for transfer or cancellation, but very few unsuccessful respondents in UDRP proceedings take such court proceedings.

<sup>23</sup> *The Estate of Marlon Brando v WhoisGuard c/o WhoisGuard Protected*, NAF Case No FA0506000503817.

### **33. 3. Elements of the Uniform Name Dispute Resolution Process**

The first thing the complainant has to prove in the UDRP process is that they have a trademark in their own name. Then, the complainant has to prove the following three things:

- (1) that the domain name is identical or confusingly similar to a trademark or service mark in which the complainant has rights; and
- (2) that the respondent has no rights or legitimate interests in respect of the domain name; and
- (3) that the domain name has been registered and is being used in bad faith.

Therefore, the basis of the UDRP process is that the complainant — the party bringing the claim — has a trademark or service mark in the same name or a similar name as the domain name that is being complained about. So, if the Coca Cola Co is complaining that someone has registered the domain name <cocacola07.com>, <bestcocacola.com> or <cocacolafizz.net>, it will have to prove that it has a trademark in the exact name as the registered domain name or a trademark that is confusingly similar to it. Coca Cola Co could, for example, argue <cocacolafizz.net> is confusingly similar to the trademark Coca Cola. So, the complainant who brings the complaint is the trademark owner, in our case the celebrity. The respondent is the party who has registered the domain name and is sometimes called the registrant.

There has been a lot of debate about why it should be that only trademark owners may have access to the fast-track UDRP process. Those who do not have trademarks can only sue in the courts, even if they have legitimate and reasonable complaints about registered domain names. Whilst this is not the place to debate this issue, it is worthwhile noting that there is such a debate.

#### **ix. Alternative Dispute Resolution Schemes**

Under some dispute resolution schemes for domain names, trademarks do not need to be proven. For example, under the Australian scheme for complaints on ‘.com.au’ domain names, or the Australian country code as it is called, a complainant must establish that he or she has rights in ‘... a name [Note 1], trademark or service mark’. The note referred to tells us that, for the purposes of this policy, .au Domain Administration Ltd (auDA) has determined that a ‘name ... in which the complainant has rights’ refers to:

- a) the complainant’s company, business or other legal or trading name, as registered with the relevant Australian government authority; or
- b) the complainant’s personal name.<sup>24</sup>

So, if the domain name being complained about is someone’s personal name, the complainant only needs to prove that fact to get to first base. It would be unnecessary for the complainant to establish they have a trademark in his or her own name.

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<sup>24</sup> *.au Dispute Resolution Policy (auDRP)* (2008-01), The Australian Domain Name Administrator, <<http://www.ada.org.au>> at 13 June 2009.

Likewise, in the new European ‘.eu’ scheme, the complainant only needs to show he or she has a right described as ‘a name in respect of which a right is recognised or established by national and/or community law, such as the rights mentioned in Article 10(1) ...’.

The examples given in Art 10(1) are:

... registered national and community trademarks, geographical indications or designations of origin, and, in as far as they are protected under national law in the Member-State where they are held: unregistered trademarks, trade names, business identifiers, company names, family names, and distinctive titles of protected literary and artistic works.

Again, that is much wider than the requirements of the UDRP scheme. For example, a family name protected under the national law of the country in question will be sufficient in the .eu scheme. The complainant could bring a complaint on the basis that someone has improperly used his or her family name as a domain name. Regardless of whether the complainant has an unregistered trademark in the name, he or she could bring a complaint to the Czech Arbitration Court.

### **ixi. Resolution of Celebrity Domain Name Disputes**

Unfortunately for celebrities, cybersquatters tend to use celebrity names in the big league of .com, .net and .org domain names. These types of domain names require celebrities to prove they have a trademark or service mark in their own name. Once that has been established, the tribunal uses the three tests mentioned above to decide whether the complainant or celebrity has made out the three required elements. First, the domain name is identical to the trademark or confusingly similar to it. Second, the person who registered the domain name had no right to register it. Third, the domain name in question was registered and used in bad faith. If all these elements are made out, the celebrity or other complainant will have the domain name transferred to them or cancelled.

## **34. 4. The Need to Prove the Existence of a Trademark for the UDRP Process**

Getting to first base is important and sometimes the most difficult thing for the complainant to prove. In fact, quite a few complainants actually lose their cases by not being able to prove a registered or unregistered trademark.<sup>25</sup>

It is often difficult for companies, even in countries which recognise unregistered trademarks, to establish they have unregistered trademarks.<sup>26</sup> Such companies must establish the name, sign, symbol or whatever other device is their trademark because it is strongly associated

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<sup>25</sup> For example, see *David Pecker v Mr Ferris*, WIPO Case No D2006-1514.

<sup>26</sup> For example, an Italian telephone company unsuccessfully claimed it had an unregistered trademark over the numbers ‘187’ because it was the number for customer assistance on the Italian telephone system: *Telecom Italia SpA v NetGears LLC c/o Domain Admin*, NAF Case No FA0944807; a German postal company unsuccessfully claimed that it had an unregistered trademark over the word ‘post’: *Deutsche Post AG v NJDomains*, WIPO Case No D2006-0001; and in *WOW Audio Visual Superstores Pty Ltd v Comonoz Pty Ltd*, WIPO Case No DAU2007-0003, a company unsuccessfully claimed to have an unregistered trademark over the exclamation ‘wow’.

with only their products or services. Whilst it is a challenge, companies can and regularly do, succeed in this task.

However, it is harder for celebrities and other individuals to establish unregistered trademarks in their names because they are individuals. They typically do not have goods or products to show that they have a trademark in their name. Therefore, celebrities must show they have a trademark in their own name. Merely to state the rule in that way makes it clear that it is not an easy thing to do.

Very few people would think that they had a trademark in their own name, partly because they would not regard themselves as being in trade. Yet this is what they must prove if they want to use the UDRP scheme to prise back a domain name that someone else has registered. So how does the celebrity get to first base? How does the celebrity show that he or she has a trademark in his or her own name?

### **Ixii. Registered Trademarks**

The complainant may be fortunate enough to have a registered trademark, which solves the whole problem of proving the existence of the necessary trademark. Some of the most prominent celebrities who are household names — and clearly those who obtain the best legal advice — have registered trademarks. For example, the singer Madonna has relied on her registered and unregistered trademark to succeed in her claim.<sup>27</sup> Likewise, in another case the Rolling Stones had clearly covered themselves by a long string of registered trademarks.<sup>28</sup> In the *Jimi Hendrix Fan Club Case*, Jimi Hendrix's estate was held to have registered and unregistered trademarks. He also succeeded in his claim on that basis.<sup>29</sup>

There are many more examples of celebrities who have succeeded on the basis of a registered trademark. J K Rowling, the author of the Harry Potter novels, was found to have a registered trademark in her own name. This fact put her well on the way to succeed in several cases and retrieve various domain names.<sup>30</sup> On the subject of Harry Potter, it is probably appropriate to mention here the decision in *Time Warner Entertainment Company, LP v HarperStephens*.<sup>31</sup> In that case it was held that a state registration of a trademark in the United States was sufficient to bring a successful UDRP case. Although in other cases it has been held that a federal registration is required.

The works of the other literary icon, Tolkien, are also subject to registered trademarks.<sup>32</sup> A company representing a group of celebrities also had the foresight to register the trademarks of the New York Yankees.<sup>33</sup> Likewise, the celebrity outfitters Abercrombie & Fitch Stores Inc had registered trademarks, which stood them in good stead in two cases. In 2000 they

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<sup>27</sup> *Madonna Ciccone, p/k/a Madonna v Dan Parisi and 'Madonna.com'*, WIPO Case No D2000-0847.

<sup>28</sup> *Musidor BV v Jung Hochul*, NAF Case No FA0112000103053.

<sup>29</sup> *Experience Hendrix, LLC v Denny Hammerton and The Jimi Hendrix Fan Club*, WIPO Case No D2000-0364.

<sup>30</sup> *Joanne Rowling v Alvaro Collazo*, WIPO Case No D2004-0787; and *Joanne Rowling v Hostine.net*, WIPO Case No DIR2006-0004.

<sup>31</sup> WIPO Case No D2000-1254.

<sup>32</sup> *JRR Tolkien Estate Limited v tolkien.net*, WIPO Case No D2003-0833; and *JRR Tolkien Estate Limited v Network Operations Center, Alberta Hot Rods*, WIPO Case No D2003-0837.

<sup>33</sup> *New York Yankees Partnership d/b/a The New York Yankees Baseball Club v Covanta Corporation*, NAF Case No FA060900080327.

took on the doyen of cybersquatting domain name registrants, John Zuccarini,<sup>34</sup> relied on their registered trademarks and won.<sup>35</sup> Three years later they had another fight<sup>36</sup> where the panel was able to rely on the company's registered trademarks.

Footballers also seem to be well protected by registered trademarks as was seen in the cases of Pelé, the Brazilian footballer,<sup>37</sup> English soccer player Wayne Rooney,<sup>38</sup> and Dutch soccer player Pierre van Hooijdonk.<sup>39</sup> Jaap Stam, a professional football player who played in Holland and for Manchester United, also had registered trademarks and succeeded in domain name proceedings.<sup>40</sup> The Formula 1 driver Mika Häkkinen was also successful in relying on his registered trademark in *Mr Mika Häkkinen v 'For SALE'*.<sup>41</sup>

Returning to the entertainers, we find that the band Metallica also had a registered trademark and used it to advantage.<sup>42</sup> As did a Chinese-American entrepreneur and television personality in *Yue-Sai Kan et al v Gong Gen Yuan et al*.<sup>43</sup>

Without it being necessary to say much more about them other than to list them, here are some more cases based on registered trademarks: *Warner Bros Entertainment Inc v Chris Sadler*,<sup>44</sup> concerning more Harry Potter domain names, <shop4harrypotter.com> and <shopforharrypotter.com>; *Warner Bros Entertainment Inc v Vivek Rana*,<sup>45</sup> concerning <harrypottercollection.com>; *Time Warner, Inc v Alvaro Collazo*,<sup>46</sup> concerning domain names like <compsuerve.com>, <copmpuserve.com>, <harrupotter.com>, <harrypotterandtheorderofphoenix.com>, <lordiftherings.net>, <thesopranos.net> and that ever popular way of spelling domain names to catch the unwary, by making the 'www' part of the domain name, as in <wwwtimewarnercable.com>; *DC Comics, Turner Entertainment Co and Warner Bros Entertainment Inc v IQ Management Corporation*,<sup>47</sup> concerning <batman-costume.com>, <gilligansisland.com>; *Warner Bros Entertainment Inc v SCS Collectibles*,<sup>48</sup> concerning <harrypotterville.com>; and *Sheryl Crow v LOVEARTH*.<sup>49</sup> For a recent illustration concerning Marlene Dietrich, see *Die Marlene Dietrich Collection GmbH v Johan Duplesis Du Plesis*.<sup>50</sup>

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<sup>34</sup> *Abercrombie & Fitch Stores, Inc and A & F Trademark, Inc v John Zuccarini d/b/a Cupcake Patrol*, WIPO Case No D2000-1004.

<sup>35</sup> In another case, a celebrity clothing designer was able to rely on an unregistered or common law trademark: *Sound Unseen, Ltd; Apple Bottoms, LLC; and Cornell Haynes p/k/a 'Nelly' v Patrick Vanderhorst*, WIPO Case No D2005-0636.

<sup>36</sup> *A & F Trademark, Inc, Abercrombie & Fitch Stores, Inc, Abercrombie & Fitch Trading Co, Inc v Party Night, Inc*, WIPO Case No D2003-0172.

<sup>37</sup> *Glory Establishment v FutbolMasters Ltd, FW, FM, Steve Leighton*, WIPO Case No D2007-0439.

<sup>38</sup> *Stoneygate 48 Limited and Wayne Mark Rooney v Huw Marshall*, WIPO Case No D2006-0916.

<sup>39</sup> *Pierre van Hooijdonk v SB Tait*, WIPO Case No D2000-1068.

<sup>40</sup> *Jaap Stam v Oliver Cohen*, WIPO Case No D2000-1061.

<sup>41</sup> WIPO Case No D2001-1306.

<sup>42</sup> *Metallica v Josh Schneider*, NAF Case No FA0095636.

<sup>43</sup> WIPO Case No D2001-0548.

<sup>44</sup> NAF Case No 250236.

<sup>45</sup> NAF Case No 304696.

<sup>46</sup> NAF Case No 338464.

<sup>47</sup> NAF Case No 514423.

<sup>48</sup> NAF Case No 661419.

<sup>49</sup> NAF Case No FA203208.

<sup>50</sup> WIPO Case No D2007-1306.

Here are some cases of musicians who have succeeded in UDRP proceedings relying on registered trademarks: *Experience Hendrix, LLC v Denny Hammerton and The Jimi Hendrix Fan Club*,<sup>51</sup> *Laurence Fontaine v Visiotex SA*,<sup>52</sup> concerning the ‘adult’ singer and entertainer Laurens Sainclair; Alain Delon in *Alain Delon Diffusion SA v Unimetal Sanayi ve Tic AS*,<sup>53</sup> *Gene Klein a/k/a Gene Simmons, Gene Simmons Company, and Kiss Catalog, Ltd v Darryl Boyd*,<sup>54</sup> *Herederos de Manuel De Falla C v Music Sales Group*,<sup>55</sup> concerning <manueldefalla.com>; *Laure Pester (Lorie) and Sony Music Entertainment France SA v Movie Name*,<sup>56</sup> concerning the French singer; *Peter Frampton v Frampton Enterprises, Inc*,<sup>57</sup> *Isabel Preysler Arrastia v Ediciones Delfin, SL*,<sup>58</sup> *Tour de Charme, SARL, Sony Music, Entertainment (Holland) BV v Mademoiselle Patricia Kaas contre Stars en Direct*,<sup>59</sup> and *Robbie Williams v Howard Taylor*.<sup>60</sup>

Branching out into more exotic forms of entertainment, in *Nora Baumberger v SAND WebNames — For Sale*,<sup>61</sup> the complainant was described by the panellist somewhat tautologically as ‘a pornographic pornography star known under the pseudonym ‘Dolly Buster’. She was successful in relying on her registered German and European Community trademarks and in winning the proceeding.

As we have seen, literary works sometimes have registered trademarks, as in *Anne of Green Gables Licensing Authority, Inc, v Internetworks*,<sup>62</sup> concerning the domain name <anneofgreengables.com>. There was also a registered trademark over the Little Prince, or more accurately Le Petit Prince.<sup>63</sup> The domain name was <thelittleprince.com>, but the trademark was LE PETIT PRINCE, giving rise to the interesting question whether a domain name could be identical or confusingly similar to a trademark that was in a different language. The panel resolved this question in the affirmative when they said:

However a semantic similarity between a trademark and a domain name can also exist if the trademark and the domain name contain word elements of different languages if a considerable part of the public understands the meaning of the translation. See e.g. *Compagnie Generale Des Etablissements Michelin — Michelin & Cie. v. Graeme Foster*, WIPO Case No. D2004-0279. The Panel observes that Complainant’s registered trademark is identical with the English translation of Complainant’s trademark and title ‘Le Petit Prince’ and that the English title ‘The Little Prince’ of Saint Exupéry’s novel is well known in the English speaking world.

A business person successful with a registered trademark over her name was the female Chinese-American entrepreneur and television personality Yue-Sai Kan.<sup>64</sup> Another

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<sup>51</sup> WIPO Case No D2000-0364.

<sup>52</sup> WIPO Case No D2001-0071.

<sup>53</sup> WIPO Case No D2000-0989.

<sup>54</sup> WIPO Case No D2001-0183.

<sup>55</sup> WIPO Case No D2001-1234.

<sup>56</sup> WIPO Case No D2003-0312.

<sup>57</sup> WIPO Case No D2002-0141.

<sup>58</sup> WIPO Case No D2001-0298.

<sup>59</sup> WIPO Case No D2002-0733.

<sup>60</sup> WIPO Case No D2002-0588.

<sup>61</sup> WIPO Case No D2001-0502.

<sup>62</sup> AF-00109 (eResolution Case, 2000).

<sup>63</sup> *Société pour l’Oeuvre et la Mémoire d’Antoine de Saint Exupéry — Succession Saint Exupéry — D’Agay v Perlegos Properties*, WIPO Case No D2005-1085.

<sup>64</sup> *Yue-Sai Kan et al v Gong Gen Yuan et al*, WIPO Case No D2001-0548.

interesting case of a business person succeeding by relying on a registered trademark was Dodi Al Fayed in *Harrods Limited v Robert Boyd*.<sup>65</sup> In that case, the domain name at issue was not Harrods but <dodialfayed.com>. The trademark DODI FAYED was registered by Harrods as a European Community Trademark. After registering the domain name, the respondent placed it for sale at an auction website with an asking price of US\$400,000. However, as Harrods succeeded in the claim the domain name was transferred. The case is interesting for two reasons First, that the complainant was seeking the transfer of a domain name that was not its own name, but an associate. Second, Harrods relied on a registered trademark that was in the name of Harrods and not in the name of the executors of the deceased Dodi Al Fayed. The complainant was allowed to rely on the registered trademark, which helped it succeed in the proceedings. As we will see later, this same issue arises in the case of unregistered or common law trademarks.

Nor is there any sign of any letting up in the practice of registering celebrity domain names, as is seen from the recent decision in *The Betty Ford Center at Eisenhower v Domain Source, Inc.*<sup>66</sup> In that case, the registered trademark was clear enough to get the case off the ground and the complainant went on to win and obtain the domain name.

In the Australian context, but under the UDRP, the Wiggles Company had registered ‘.com’ trademarks in The Wiggles and Henry The Octopus which it could rely on in the proceedings.<sup>67</sup> The panel then had no difficulty in deciding that the domain names <thewiggles.com> and <henrytheoctopus.com> were identical to those trademarks.

The examples provided above show that sometimes in UDRP proceedings trademarks have been fortuitously obtained and complainants have legitimately relied on them,

#### **j. Does it Matter Where the Trademark was Registered?**

So long as the trademark is registered, it does not seem to matter in which country it was registered: *Bernardka Pulko v Greg Frazier*.<sup>68</sup> Ms Pulko is truly unique. She was the first human being to travel all seven continents on a motorcycle and the first woman to ride through Saudi Arabia. She also holds the Guinness World Record for the longest motorcycle journey by a female. However, her domain name was unique for a reason other than her motorcycle travels. She had a trademark in her own name registered in Slovenia, which was enough to get her to first base in her claim. This was despite the fact that the respondent who had registered the contentious domain name was a resident in the United States. Ms Pulko then went on to succeed in the whole claim.

#### **k. Other Issues Arising from Registered Trademarks**

It will be seen as we proceed that sometimes complainants have registered and unregistered or common law trade-marks. For example, in *Stevland Morris a/k/a Stevie Wonder v Unofficial Fan Club c/o Web Maste*,<sup>69</sup> it was held that Stevie Wonder had both registered and unregistered trademarks in his own name and either could support his claim. As we will see

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<sup>65</sup> WIPO Case No D2000-0060.

<sup>66</sup> WIPO Case No D2007-09011.

<sup>67</sup> *The Wiggles Touring Pty Ltd v Thompson Media Pty Ltd*, WIPO Case No D2000-0124.

<sup>68</sup> WIPO Case No D2006-0099.

<sup>69</sup> NAF Case No FA0453986, 22 June 2005.

later, having both registered and unregistered trademarks can be very useful and in some cases vital. However, at this stage of our discussion the point is, if the complainant has a registered trademark that is enough to get the claim off to a good start.

If the complainant seeks to rely on a registered trademark, an application for registration carries no trademark rights and will thereby be insufficient. That was the case in *George Foreman Ventures LLC v Zinnia c/o Zinnia Gonzalez*.<sup>70</sup> George Foreman had filed several trademark registrations with the United States Patent and Trademark Office for the GEORGE FOREMAN mark. He had then assigned them to the complainant, a company of which he was the co-Chairman. Since it had been held many times that mere applications for trademarks did not confer trademark rights, George Foreman could not rely on these trademark applications. The complainant had to thereby go further and argue it had a common law trademark in George Foreman's name. After the complainant established this it went on to win the whole case.

Some strong statements on the insufficiency of applications for trademarks were also made in *The Hebrew University of Jerusalem v Alberta Hot Rods*.<sup>71</sup> That case concerned the domain name <alberteinstein.com>. It was said that:

Trademark registration applications do not give rise to trade mark rights: see *Aspen Grove, Inc v Aspen Grove*, WIPO Case No. D2001-0798 and *Spencer Douglass MGA v Absolute Bonding Corporation*, WIPO Case No. D2001-0904.

See also, to the same effect, *First Tuesday Limited v The Startup Generator*<sup>72</sup> and *Mk-Net-Work v IVE Technologies*.<sup>73</sup>

However, on occasions, panels seem to have accepted that mere applications for trademarks are sufficient. See the discussion in *Fashiontv.com GmbH v Mr Chris Olic*<sup>74</sup> and Lindsay, *International Domain Name Law ICANN and the UDRP* (2007). Further, an application for a federal registered trademark has been held to be at least partially sufficient in *Kendra Todd v Real Estate Radio c/o Leo Miller*<sup>75</sup> and in *Princess Diana Case, CMG Worldwide, Inc v Naughty Page*.<sup>76</sup>

Faced with these conflicting decisions, it would therefore be prudent to establish a registered trademark in whatever jurisdiction is relevant. If that fails it would be prudent to adduce evidence in the complaint to show that the complainant has had an unregistered trademark for as long as possible. Personal names that have not taken on the additional quality of unregistered trademarks are certainly not sufficient under the UDRP.<sup>77</sup>

It has also been generally held that only federal registration of United States trademarks is sufficient and state registrations are insufficient. However, in *Kendra Todd v Real Estate*

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<sup>70</sup> NAF Case No FA0599036.

<sup>71</sup> WIPO Case No D2002-0616.

<sup>72</sup> WIPO Case No D2000-1732.

<sup>73</sup> WIPO Case No D2004-0302.

<sup>74</sup> WIPO Case No D2005-0994.

<sup>75</sup> NAF Case No FA0783428.

<sup>76</sup> NAF Case No FA0095641.

<sup>77</sup> On personal names as such, see the discussion on the Second WIPO Internet Domain Name Process at <<http://www.wipo.int/amc/en/processes/process2/index.html>>.

*Radio c/o Leo Miller*<sup>78</sup> a decision was made to the effect that a state registration is adequate, at least in part. One wonders, therefore, just how universally true it is to say that only federal registrations are sufficient. The panel in that case stated:

The Panel finds that Complainant has established trademark rights in the KENDRA TODD mark through a State Service Mark registration, an application with the USPTO, and because the mark is Complainant's given and used personal name. See *Lee Enters, Inc v Polanski*, FA 135619 (Nat Arb Forum Jan 22, 2003) (finding evidence that the complainant had established rights in the BILLINGS GAZETTE mark through registration with the Montana and Wyoming state trademark officials) ...

Note also that the trademark rights must exist at the time the complaint under the UDRP is being brought.<sup>79</sup> Accordingly, if the celebrity has a trademark registered in his or her own name that will be enough to form the basis for a successful domain name claim under the UDRP.

### **Ixiii. Unregistered Trademarks**

It is not very surprising, however, to find that most celebrities do not have registered trademarks in their own names. The explanation is that they probably do not get around to it or their advisers do not recognise its importance. The question then arises, if the celebrity does not have a registered trademark, will an unregistered or common law trademark be sufficient?

The answer is yes: unregistered trademarks are sufficient to commence UDRP proceedings. See, initially, *McCarthy on Trademarks and Unfair Competition*;<sup>80</sup> *MatchNet PLC v MAC Trading*;<sup>81</sup> and *British Broadcasting Corp v Renteria*.<sup>82</sup> See also, the discussion on this and other issues in Lindsay, *International Domain Name Law ICANN and the UDRP* (2007).<sup>83</sup>

As hinted at previously, unregistered trademarks can be very important. If the complainant registered the trademark after the domain name was registered, he or she may have difficulty establishing bad faith. It would be hard to establish that the person who registered the domain name did so to trample on the rights of a trademark owner if the trademark was not in existence to trample on. However, if the complainant also has common law rights which pre-date the registration of the domain name that is enough to get the complainant to first base. That was the case in *2001 White Castle Way, Inc v Glyn O Jacobs*.<sup>84</sup> Therefore, if the complainant can establish an unregistered or common law trademark, it will be able to bring a UDRP complaint. This could be very valuable for celebrity applicants.

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<sup>78</sup> NAF Case No FA0783428.

<sup>79</sup> *R E 'Ted' Turner and Ted Turner Film Properties, LLC v Mazen Fahmi*, WIPO Case No D2002-0251.

<sup>80</sup> 25:74.2, vol 4 (2000).

<sup>81</sup> WIPO Case No D2000-0205.

<sup>82</sup> WIPO Case No D2000-0050. The author noted these references when reading the decision in *Richard Juzwin v Glen Stephens Stamps*, Claim Number FA0106000097690.

<sup>83</sup> At pp 190–210.

<sup>84</sup> WIPO Case No D2004-0001.

### a. Unregistered Trademarks in Personal Names

Can individuals have unregistered trademarks in their own names? Yes, they can, but it has not always been guaranteed to get that principle accepted or to have it applied in individual cases.<sup>85</sup>

The current practice and the prevailing view on this issue are set out in the valuable WIPO *Overview of WIPO Panel Views on Selected UDRP Questions*,<sup>86</sup> where the following statement appears:

#### 1.6 Can a complainant show rights in a personal name?

Consensus view: While the UDRP does not specifically protect personal names, in situations where an unregistered personal name is being used for trade or commerce, the complainant can establish common law trademark rights in the name. Reference can be made to the test required for the common law action of passing off. Personal names that have been trademarked are protected under the UDRP.

However: The name in question should be actually used in trade or commerce to establish unregistered trademark rights. Merely having a famous name (such as a businessman, or religious leader) is not necessarily sufficient to show unregistered trademark rights.<sup>87</sup>

We will see from many decisions that it is possible, with adequate evidence, for individuals to establish unregistered trademarks in their own names.

Apart from the requirement for good evidence to establish unregistered trademarks, another difficulty may be that the name of the individual or celebrity may be difficult or incapable of being obtained. This is shown by one of the early cases, which concerned the singer Sting: *Gordon Sumner, p/k/a Sting v Michael Urvan*.<sup>88</sup> The panel said:

This Administrative Panel is inclined to the view, therefore, that the Complainant's name STING is not a trademark or service mark within the scope of paragraph 4(a)(i) of the Uniform Policy.

The panel accepted that there had been previous cases where it had been held that the individual names of entertainers had been accepted as unregistered trademarks. However, that did not mean that all such individual names would qualify as trademarks. As the panel said:

Unlike the personal names in issue in the cases *Julia Fiona Roberts v Russell Boyd*, *Jeannette Winterson v Mark Hogarth*, and *Steven Rattner v BuyThisDomainName (John Pepin)*, *the personal name in this case (i.e. 'sting') is also a common word in the English language, with a number of different meanings* [emphasis added].

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<sup>85</sup> See the discussion on this issue in Lindsay, *International Domain Name Law ICANN and the UDRP* (2007) 210–23, which includes many examples.

<sup>86</sup> WIPO: see <<http://www.wipo.int>> and follow the links to the Overview.

<sup>87</sup> Relevant decisions: *Julia Fiona Roberts v Russell Boyd*, D2000-0210 (transfer); *Jeanette Winterson v Mark Hogarth*, D2000-0235, among others (transfer); *Dr Michael Crichton v In Stealth Mode*, D2002-0874 (transfer); *Israel Harold Asper v Communication X Inc*, D2001-0540, among others (denied); *Chinmoy Kumar Ghose v ICDSOFT.com and Maria Sliwa*, D2003-0248 (transfer).

<sup>88</sup> WIPO Case No D2000-0596.

The other names were not common or generic words, but the word ‘sting’ was a common or generic word. In support of that, the panel quoted several dictionary definitions of the word, like ‘bee sting’ and a ‘trap for criminals’, as in the eponymous film. When coming to this conclusion, the panel was also influenced by the wider notion of whether the ICANN Policy was intended to protect personal rights. However, at least modern practice suggests an individual may be found to have common law trademark rights in their personal name.

Clearly, it would be useful to have a good working test to enable parties and their advisers to reach an informed judgment on whether the facts of an individual case go to establish a common law trademark in a personal name. In that regard, the *WIPO Overview*<sup>89</sup> contains the valuable statement:

The name in question should be actually used in trade or commerce to establish unregistered trademark rights. Merely having a famous name (such as a businessman, or religious leader) is not necessarily sufficient to show unregistered trademark rights.

On the evidence required, the *WIPO Overview*<sup>90</sup> also says:

1.7 What needs to be shown for the complainant to successfully assert common-law or unregistered trademark rights?

Consensus view: The complainant must show that the name has become a distinctive identifier associated with the complainant or its goods and services. Relevant evidence of such ‘secondary meaning’ includes length and amount of sales under the mark, the nature and extent of advertising, consumer surveys and media recognition. The fact that the secondary meaning may only exist in a small geographic area does not limit complainant’s rights in a common law trademark. Unregistered rights can arise even when the complainant is based in a civil law jurisdiction.<sup>91</sup>

Lindsay has stated the requirement that:

The upshot of the analysis undertaken in these decisions is that the preferred view is that, to be protected as a common law mark, a famous personal name *must have acquired a secondary meaning so as to function as an identifier of goods or services* ... Merely having a famous name, however, is not sufficient for there to be common law rights, *even if the fame results from commercial activities* [emphasis added].<sup>92</sup>

Beyond that, the jurisprudence and the practice of panellists in making decisions on this issue must be found from the decisions themselves. We must therefore turn to some of those decisions.

As a starting point it might be useful to cite a recent decision, *Anna Nicole Smith c/o CMG Worldwide v DNS Research, Inc*<sup>93</sup> to show the high standard of evidence that will be

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<sup>89</sup> *Ibid* n 86.

<sup>90</sup> *Ibid*.

<sup>91</sup> Relevant decisions: *Uitgeverij Crux v W Frederic Isler*, D2000-0575 (transfer); *Skattedirektoratet v Eivind Nag*, D2000-1314 (transfer); *Amsec Enterprises, LC v Sharon McCall*, D2001-0083 (denied); *Australian Trade Commission v Matthew Reader*, D2002-0786 (transfer); *Imperial College v Christophe Dessimoz*, D2004-0322 (transfer).

<sup>92</sup> *Supra* n 76 at 219.

<sup>93</sup> NAF Case No FA00220007.

required, even where, as in that case, the personality concerned was a household name. The panel said:

... the mere fact of having a successful career as an actress, singer or TV program star does not provide exclusive rights to the use of a name under the trademark laws. The cases require a clear showing of *high commercial value and significant recognition of the name as solely that of the performer* [emphasis added].

For some wider reading, note also the contrast that was drawn with the *Humphrey Bogart Case: Bogart, Inc v Humphrey Bogart Club*.<sup>94</sup>

The following cases will show that various celebrities have successfully established trademarks in their own names. Further, these celebrities have consequently retrieved domain names that have been registered in their names without permission. It is worthwhile looking at these cases to see why it was held that the celebrities concerned had unregistered trademarks in their own names. The actress Julia Roberts, the writer Jeanette Winterson, the musician Nick Cannon and the actress Nicole Kidman are celebrities whose names are often cited as parties who have been successful in using this principle. As we will see, however, there are many others. There are also some celebrities who have failed.

In the *Julia Roberts Case, Julia Fiona Roberts v Russell Boyd*,<sup>95</sup> the panel decided that Ms Roberts had shown sufficient secondary meaning in the name to establish a common law trademark. However, it is not a very helpful decision as it does not say how she had established such a clear secondary meaning. The closest the panel came to saying how this had happened was that she had ‘been featured in a number of motion pictures ...’. It may well have be that the panel did not want the weakness of that case to help the domain name remain in the name of an eccentric registrant of celebrity names. Some clue to the nature of the respondent is to be found in his response where he submitted: ‘If Julia Roberts had picked up a phone and said, “Hi Russ, can we talk about the domain name juliaroberts.com?” she would own it by now’. The respondent concluded by saying: ‘But as I mentioned at the beginning of this response, I still think Julia is nifty crazy wacko cool’. It is scarcely surprising that the domain name was ordered to be transferred to Julia Roberts.

The next decision on this issue was *Jeanette Winterson v Mark Hogarth*,<sup>96</sup> which was followed and applied in a large number of subsequent cases.<sup>97</sup>

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<sup>94</sup> NAF Case No FA162770 (2003).

<sup>95</sup> WIPO Case No D2000-0210.

<sup>96</sup> WIPO Case No D2000-0235.

<sup>97</sup> For example, *Rosa Montero Gallo v Galileo Asesores SL*, WIPO Case No D2000-1649; *Lorenzo Silva Amador v Galileo Asesores SL*, WIPO Case No D2000-1697; *Louis De Bernieres v Old Barn Studios Limited*, WIPO Case No D2001-0122; *Margaret Drabble v Old Barn Studios Limited*, WIPO Case No D2001-0209; *Dr Michael Crichton v Alberta Hot Rods*, WIPO Case No D2002-0872; *Jorge Antonio Labanda Blanco v Xavier Mañé*, WIPO Case No D2002-1111; *Jose Luis Sampedro Saez v Galileo Asesores*, WIPO Case No D2000-1650; *Julian Barnes v Old Barn Studios Limited*, WIPO Case No D2001-0121; *Antony Beevor v Old Barn Studios Limited*, WIPO Case No D2001-0123; *Marian Keyes v Old Barn Studios Ltd*, WIPO Case No D2002-0687; *Dr Michael Crichton v In Stealth Mode*, WIPO Case No D2002-0874; *Sibyl Avery Jackson v Jan Teluch*, WIPO Case No D2002-1180 (with qualifications); *Joe David Graedon v Modern Limited-Cayman Web Development*, WIPO Case No D2003-0640; *Jeffrey Archer v Alberta Hotrods tda CELEBRITY 1000*, WIPO Case No D2006-0431; *Fondation Le Corbusier v Mercado M*, WIPO Case No D2004-0723; *Arthur Golden v Galileo Asesores SL*, WIPO Case No D2006-1215; *Francis Newton Souza v ZWYX.org Ltd*, WIPO Case No D2007-0221.

A Canadian decision on the issue and concerning an author is *Barbara Kingsolver v Old Barn Studios, Ltd.*<sup>98</sup> The domain name was <barbarakingsolver.com>. The evidence was that the complainant was ‘author of a number of bestselling books of fiction and nonfiction’. The panel also noted that ‘... the complainant’s claim is the same as the claim sustained on January 8, 2000 against this same respondent, Old Barn Studios, Limited, in a proceeding brought by The Authors Guild on behalf of nine authors’. The panel in its decision on the issue merely stated: ‘The complainant has presented evidence that her name enjoys common law trademark protection in at least the USA and the UK’.

Interestingly, the trademark may also be established in a product such as Mr Trump’s Trump Ice water: *Donald J Trump v Fountainhead Entertainment LLC*,<sup>99</sup> where the domain name was <trumpice.com>. However, there was an apparently conflicting decision in *Donald J Trump and Trump Hotel & Casino Resorts, Inc v olegevtushenko a/k/a Oleg Evtushenko*.<sup>100</sup> In that case it was held that the domain name <porntrumps.com> was not confusingly similar to the TRUMP trademark because readers would not associate it with Donald Trump. Readers would associate the domain name with the notion that pornography succeeds or is paramount; that is, trumps in the card playing sense.

Let us now look at the other two of the most frequently referred to cases on this issue: those of Nick Cannon and the actress Nicole Kidman. Both were successful in using the principle and establishing an unregistered trademark in their own names which supported their UDRP claims.

In the *Nick Cannon Case*<sup>101</sup> the domain name in contention was <nickcannon.com>. The complainant was a television and film actor, a writer and producer of television programs and films and also a music composer and performer. Over the previous 10 years, the complainant had appeared in numerous television programs and motion pictures, including *The Nick Cannon Show*, *Men in Black II* (2002), *Drumline* (2002), *Love Don’t Cost a Thing* (2003), *Shall We Dance* (2004) and *Jump Shot* (2005).

The panel dealt with the claim that Cannon had common law trademark rights in his own name and eventually held, following *Roberts* and *Kidman*, that he did. The way the panel expressed it was that:

The Complainant has (shown common law trademark rights) ... in the present case in referring to his movie experience (six films, from 2002 to 2005) and his extensive career as an actor, writer, producer, and musical composer and performer under his name since the 1980s.<sup>102</sup>

This decision also contains one of the earliest statements to the effect that the principles we are presently discussing can only be used in those jurisdictions where common law trademark rights are recognised. These are, of course, only common law countries, not civil law

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<sup>98</sup> AF-0762 (eResolution Case, 25 April 2001).

<sup>99</sup> WIPO Case No D2004-0429.

<sup>100</sup> NAF Claim No FA0110000101509.

<sup>101</sup> *Nick Cannon v Modern Limited-Cayman Web Development*, WIPO Case No D2005-0757.

<sup>102</sup> *Ibid.*

countries. This distinction is now regularly used to deny some of the more optimistic claims for the recognition of unregistered trademarks in UDRP cases.<sup>103</sup>

In the *Nicole Kidman Case*,<sup>104</sup> the domain names at issue were <nicholekidman.com> and <nicolekidmannude.com>. The respondent was the well-known cybersquatter John Zuccarini. Clicking on the domain name <nicholekidman.com> sites ‘caused “pop-up” advertisements for a variety of commercial enterprises to appear’, leading to users being ‘mousetrapped’. Because of her fame and obvious commercial success it is not very surprising that the panel found that Nicole Kidman had established common law trademark rights in her own name.

In addition to those leading cases, other prominent actors have also successfully relied on unregistered trademarks, including Hugh Jackman<sup>105</sup> and Tom Cruise.<sup>106</sup> Another early success for unregistered trademark rights was the stand-up comedienne Nita Rudner.<sup>107</sup> Other actors successful in the same year were Bridget Moynahan (*Sex and the City*)<sup>108</sup> and Cem Yilmaz, a well-known Turkish comedian, caricaturist and motion picture actor.<sup>109</sup> The comedian and actor Billy Connolly<sup>110</sup> and Julia Brown<sup>111</sup> also successfully established unregistered trademark rights. In the *Julia Brown Case* the panel put the legal argument well when they said:

Authors and performers can establish trade mark rights either by showing that they have registered their names as marks for certain goods or services, or because, through deployment of the names as source indicators in commerce, they have unregistered or ‘common law’ rights to protection against misleading use.

Another case decided in early UDRP history was valuable because the decision contained a concise but helpful statement of the application of the principle. It was given in the case of the film actress Isabelle Adjani in *Isabelle Adjani v Second Orbit Communications, Inc*,<sup>112</sup> where the panel said:

The Rules paragraph 15(a) provide that a panel shall decide a complaint on the basis, inter alia, of ‘... any rules and principles of law that it deems applicable’.

The Complainant is resident in Switzerland and the Respondents give an address in the United States of America. To the extent that it assists in determining whether the Complainant has met her burden under paragraph 4a(i) of the Policy to establish that she has trademark rights in her name Isabelle Adjani, the Panel can look at applicable decision and laws of both countries. From the Julia Roberts case it seems clear that under the law of the United States of America it is possible for a well-known actress to have protectable common law trademark rights in her name. Under Swiss law it appears that the Complainant has protectable rights, akin to trademark rights, in her name.

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<sup>103</sup> For example, the domain name <187.com> in *Telecom Italia SpA v NetGears LLC c/o Domain Admin*, NAF Case No FA0944807.

<sup>104</sup> *Nicole Kidman v John Zuccarini, d/b/a Cupcake Party*, WIPO Case No D2000-1415.

<sup>105</sup> *Hugh Jackman v Peter Sun*, NAF Case No FA0248716.

<sup>106</sup> *Tom Cruise v Network Operations Center/Alberta Hot Rods*, WIPO Case No D2006-0560.

<sup>107</sup> *Rita Rudner v Internetco Corp*, WIPO Case No D2000-0581.

<sup>108</sup> *Kathryn Bridget Moynahan v Fantastic Sites, Inc*, WIPO Case No D2000-1083.

<sup>109</sup> *Cem Yilmaz v Roman Club International*, WIPO Case No D2000-1541.

<sup>110</sup> *Billy Connolly v Anthony Stewart*, WIPO Case No D2000-1549.

<sup>111</sup> *Julie Brown v Julie Brown Club*, WIPO Case No D2000-1628.

<sup>112</sup> WIPO Case No D2000-0867.

Applying case law developed under the Policy, the Panel refers to its own Decision in the Jeanette Winterson case, the Cedar Trade Associates case and, again, to the Julia Roberts case.<sup>113</sup>

Another useful decision is *Estate of Shakur v Shakur Info Page*.<sup>114</sup> Mr Tupac Shakur, often known as 2Pac or Tupac, was an internationally known hip-hop musician, actor and poet. He was murdered in 1996 at the age of 25. His recordings sold millions of copies worldwide and he appeared in several movies. The panel was able to find that he had established common law trademark rights, as '[a] person may acquire such a reputation in his or her own name as to give rise to trademark rights in that name at common law ...'. Mr Shakur had clearly done so.

Another case where common law rights were accepted concerned Pink Floyd and David Gilmour.<sup>115</sup> In that case,<sup>116</sup> the common law rights were said by the panel to be based on the following:

Although the artist has not registered his name as a trademark, he has incorporated two companies which bear his name, the second and third Complainants, which own the right to exploit his artistic services. The name David Gilmour represents the goodwill in the musical works and other projects with which the artist has been involved since the 1970's. That goodwill is fundamental to the businesses of the Complainants.

Elmore 'RIP' Torn Jr,<sup>117</sup> the actress and model Pamela Anderson<sup>118</sup> as well as Playboy model Patricia Ford,<sup>119</sup> in all their respective cases, established and relied on their common law trademark rights in their own names. Likewise, the sex therapist Dr Roger Libby,<sup>120</sup> whose name was used in a domain name linked to a hardcore pornography site, was successful.

Another early success that is often cited is *Helen Folsade Adu known as Sade v Quantum Computer Services Inc*.<sup>121</sup> It was found that although the complainant celebrity did not register the word 'SADE' either as a trademark or as a service mark, she had adapted the word SADE as her stage-name. SADE was thereby her trademark and service mark with the associated common law rights.<sup>122</sup>

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<sup>113</sup> The complainant's submission on this issue was as follows: '4.3 As a resident in Switzerland, the Complainant claims a right to her name under Arts. 28 and 29 of the Swiss Civil Code. Art. 29.2 provides: "Where a person assumes the name of another to the latter's prejudice, the latter can apply for an injunction to restrain the continuation of this assumption, and can in addition claim damages if the act is proved to be wrongful, and moral compensation if this is justified by the nature of the wrong suffered"'.  
<sup>114</sup> AF-0346 (eResolution Case, 28 September 2000).

<sup>115</sup> '... guitarist, vocalist and writer with Pink Floyd, he is also renowned for his solo work and collaborations with other artists including Kate Bush, Paul McCartney, and Pete Townshend':

<<http://www.davidgilmour.com/biography.htm>>.

<sup>116</sup> *David Gilmour Music Limited and David Gilmour Music Overseas Limited v Ermanno Cenicolla*, WIPO Case No D2000-1459.

<sup>117</sup> *Elmore 'RIP' Torn, Jr, p/k/a Rip Torn v Riptorn.com*, WIPO Case No D2001-0850.

<sup>118</sup> *Pamela Anderson v Alberta Hot Rods*, WIPO Case No D2002-1104.

<sup>119</sup> *Patricia Ford and Online Creations Inc v Damir Kruzicevic*, WIPO Case No D2001-0059.

<sup>120</sup> *Dr Roger Libby v Tunga Tuzlaci and/or Tumay Asena*, WIPO Case No D2001-1342.

<sup>121</sup> WIPO Case No D2000-0794.

<sup>122</sup> Sade is a Nigerian-English singer and composer who won a Grammy award.

A prominent successful case in 2000 was Madonna in *Madonna Ciccone, p/k/a Madonna v Dan Parisi and 'Madonna.com'*.<sup>123</sup> In this case, the panel decided that panels should make decisions on questions of fact, even if the test was on the balance of probabilities. This was one of the earliest cases where that test was laid down. The panel rejected the respondent's claim that it had a right or legitimate interest in the domain name because before the dispute it had used the domain name for an adult entertainment site. The panel accepted that that use had been made of the domain name, as a matter of fact. However, it found that it was not a *bona fide* use because other than Madonna's fame there was no alternative explanation why the name Madonna was chosen.

Another often cited 2000 case concerns a Korean singer, Cho Yong Pil or 'Cho Young-Pil'.<sup>124</sup> In that case, the complainant submitted materials which showed that Cho Yong Pil was a famous Korean pop music artist who performed, recorded, and sold records, CDs, cassettes, and related music products under the name 'Cho Yong Pil' or 'Cho Yong-Pil'. The materials also showed the name Cho Yong Pil had been used in association with his music products and performances over 30 years in Korea and internationally. The decision on this issue was:

Here, the passing off is likely given Cho Yong Pil's fame, especially in Korea and Asia. Accordingly, the Panel determines that the Complainant has shown that the fame in his name Cho Yong Pil is sufficient to give the Complainant trademark or service mark rights for the purpose of the Rules. The Panel thus concludes that the domain name <CHOYONGPIL.COM> is identical or confusingly similar to the Complainant's mark, Cho Yong Pil.

Another case of an actor who succeeded in establishing common law rights in two cases, in 2001 and 2002, was Kevin Spacey.<sup>125</sup> It is useful to note some of the other celebrity cases that have relied on there being an unregistered or common law trademark, and any interesting feature of the cases. In particular, we should also mention other entertainers who have reached celebrity status and have been able to avail themselves of common law trademarks in these proceedings. In *Dame Elizabeth Taylor, The Elizabeth Taylor Cosmetics Company & Interplanet Productions Limited v Day After c/o Robert Chafino*,<sup>126</sup> the domain names at issue were <houseoftaylorjewelry.com> and <houseoftaylorjewelry.net>. The celebrity complainant was able to rely on her common law trademark to succeed. The ever-popular Celine Dion has done the same.<sup>127</sup> Some other cases where entertainers succeeded in establishing common law trademark rights were: *Estate of Stanley Getz aka Stan Getz v Peter Vogel*,<sup>128</sup> *Edward Van Halen v Deborah Morgan*,<sup>129</sup> *Tracy Marrow p/k/a 'ICE-T' v iceT.com a/k/a Sverrir Geirmundsson*,<sup>130</sup> *Bill Withers v Robert Dominico et al*,<sup>131</sup> *Roy Harper v The*

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<sup>123</sup> WIPO Case No D2000-0847.

<sup>124</sup> *Cho Yong Pil v ImageLand, Inc*, WIPO Case No D2000-0229.

<sup>125</sup> *Kevin Spacey v John Zuccarini*, NAF Claim No FA0096937; and *Kevin Spacey v Alberta Hot Rods*, NAF Case No FA0114437, respectively.

<sup>126</sup> NAF Case No FA0653586.

<sup>127</sup> *Celine Dion and Sony Music Entertainment (Canada) Inc v Jeff Burgar operating or carrying on business as Celine Dion Club*, WIPO Case No D2000-1838.

<sup>128</sup> WIPO Case No D2000-0773.

<sup>129</sup> WIPO Case No D2000-1313.

<sup>130</sup> WIPO Case No D2000-1234.

<sup>131</sup> WIPO Case No D2000-1621.

*Reprahduce Company*,<sup>132</sup> *Michael J Feinstein v PAWS Video Production*,<sup>133</sup> and *Lara Crokaert and Les Productions Clandestines v Buy This Domain Web Master*.<sup>134</sup>

Among the more exotic cases of entertainers who were successful in their claims are *DM Entertainment Pvt Ltd v Mr Hemant Kumar*.<sup>135</sup> The panel described the case as concerning ‘... probably the most famous contemporary Punjabi performing artist, composer and lyricist’. There is also a similar case which concerned the adult video entertainer Sylvia Saint.<sup>136</sup> There was a similar result in *Carlos Santana v Domain Sales a/k/a ##### This Domain Name is For Sale #####*,<sup>137</sup> concerning the rock artist Santana, and *Utada Hikaru v Leonard Meng Lee*.<sup>138</sup>

The next case worth looking at is the case of Vin Diesel, aka Mark Vincent (Saving Private Ryan).<sup>139</sup> He was held to have a common law trademark right because of his wide fame and sales of his products. The respondent’s domain name, <vindiesel.com>, resolved to a commercial website featuring links to various content unrelated to the complainant. It was held to be identical to the complainant’s VIN DIESEL trademark. Although this is jumping ahead in the analysis, this showed that the respondent had no legitimate interest. It also demonstrated the respondent had registered and used the domain name in bad faith.

It should also be noted that a production company may have a common law trademark in the name of its production or the show itself by announcing it, even if such a trademark was acquired only one day before the domain name was registered.<sup>140</sup> The issue of the common law trademark seems to have spanned the entire life of the UDRP. It is no surprise that a recent case established common law trademarks in the name of the deceased famous dancer and actor Gene Kelly, so that his trust could bring a complaint under the UDRP.<sup>141</sup>

Moving away from film star celebrities, another recent case concerning the abstract expressionist painter Sam Francis, raised some interesting issues.<sup>142</sup> This is an interesting decision for several reasons. First, it is one of the few decisions, although not a unique one, where there were three panellists deciding the case and a dissenting decision. Second, the dissent was perhaps more significant in the sense that it was the presiding panellist who dissented.

The respondent registered <samfrancis.com> and used it to sell Sam Francis paintings. The website never falsely claimed to be Sam Francis’ virtual art gallery. However, the panel found the name ‘Sam Francis’ had come to be associated exclusively with Sam Francis paintings.

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<sup>132</sup> WIPO Case No D2001-0647.

<sup>133</sup> WIPO Case No D2000-0880.

<sup>134</sup> WIPO Case No D2002-0062.

<sup>135</sup> WIPO Case No D2001-1267.

<sup>136</sup> *Silvie Tomalová aka Sylvia Saint v Juan Campos*, WIPO Case No D2006-0379.

<sup>137</sup> NAF Case No FA0222189.

<sup>138</sup> WIPO Case No D2007-0366 .

<sup>139</sup> *Vin Diesel v LMN a/k/a LM Nordell*, NAF Case No FA0804924.

<sup>140</sup> *True Blue Productions, Inc v Chris Hoffman*, WIPO Case No D2004-0930.

<sup>141</sup> *Gene Kelly Image Trust v BWI Domain Manager*, WIPO Case No D2008-0342.

<sup>142</sup> *Frederick M Nicholas, Administrator, The Sam Francis Estate v Magidson Fine Art, Inc*, WIPO Case No D2000-0673.

The panel then made an observation that was pivotal to deciding the case. It said:

The existence of a common law trademark or service mark does not prohibit art collectors or the general public from referring to a piece as a ‘Sam Francis’ work. The existence of a common law trademark or service mark does prohibit the use of the phrase ‘Sam Francis’ in a manner denoting that a gallery or exhibition, whether physical or virtual, is sponsored or authorised by Sam Francis or his Estate.

We will see that this was a particularly significant observation. However, for the moment we will just note that common law trademark rights were established and held to have been adequate in UDRP proceedings.

Another painter who was similarly held to have common law trademark rights in her own name was George-Marie Glover.<sup>143</sup> She had worked under that name for 15 years and won rights to the domain name but curiously, is not using it. Perhaps it was one of those cases where the celebrity wants to stop some unauthorised person from holding and using the domain name, but does not really want it.<sup>144</sup> The Spanish painter Antonio de Felipe also won common law trademark rights in his name as his works in some London exhibitions were priced in pounds sterling.<sup>145</sup> There was also held to be bad faith registration and use of the domain name because the website resolved to another website where downloads and ringtones could be purchased.

Interestingly, common law trademark rights over the domain names <princessdi.com> and <princessdiana.com> were also made out for an unusual complainant who:

... is in the business of representing living and deceased celebrities and the heirs, families and estates of the deceased celebrities for the purpose of licensing to third parties permission to commercially utilize among other things the names of said celebrities together with trademarks and related rights associated with the same. Complainant is the authorized representative for The Diana, Princess of Wales Memorial Fund, the only officially recognized body dedicated exclusively to continuing the work of the late Diana Spencer with the full approval of her estate.<sup>146</sup>

Similarly, Morgan Freeman was held to have common law trademark rights in his name as it had been used to indicate he was the source of goods or services in trade or commerce.<sup>147</sup>

This discussion would not be complete without a mention of one of the several Beatles cases. This one concerned Linda and Paul McCartney.<sup>148</sup> The domain names were ‘linda-mccartney.net’, ‘lindamccartney.com’ and ‘paulmccartney.com’. The decision clearly would have benefited from a better arguing out of the principles involved, at least with respect to Linda McCartney. The panel seemed to assume common law rights as it simply said:

The Complainant owns the rights to the common-law and registered trademarks and service marks of Sir Paul McCartney and his wife, the late Linda McCartney.

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<sup>143</sup> *George-Marie Glover and George-Marie Glover, LLC v Cherie Pogue*, WIPO Case No D2001-0600.

<sup>144</sup> Another artist covered by the principle was Thomas Blackshear in *Thomas Blackshear v Christ-Centered Mall, Inc*, WIPO Case No D2002-0736.

<sup>145</sup> *Antonio de Felipe v Registerfly.com*, WIPO Case No D2005-0969.

<sup>146</sup> *CMG Worldwide, Inc v Naughty Page*, NAF Case No FA0095641.

<sup>147</sup> *Morgan Freeman v Mighty LLC*, WIPO Case No D2005-0263.

<sup>148</sup> *MPL Communications Limited v Denny Hammerton*, NAF Case No FA095633.

Sir Paul McCartney is a well-known international recording artist. He began his career in 1960 as a member of The Beatles. Sir Paul married Linda Eastman McCartney in 1969. Linda gained her own notoriety as a photographer. She was also known as an animal rights activist, which led her to publishing several vegetarian cookbooks as well as a series of ready-made vegetarian meals. They performed together, both on recorded medium and live world tours, and also authored a collection of songs.<sup>149</sup>

With respect, the panel should have explained why Mrs McCartney had acquired common law trademark rights, although in Mr McCartney's case it was probably self-evident.

Not surprisingly, in 2001 another Beatle, George Harrison, was held to have also established common law trademark rights in his own name.<sup>150</sup> In 2001 a panellist made it clear the decision was based on the common law trademark rights in the name Paul McCartney as much as the registered trademark.<sup>151</sup> In another Beatles case it was similarly held that common law trademark rights to the domain name <epaulmccartney.com> predated the registration of the domain names.<sup>152</sup> Mick Jagger has also recently been held to have common law trademark rights in his name.<sup>153</sup>

In this frequently-cited case, the famous horse trainer or 'horse whisperer', Monty Roberts, established common law rights in his name.<sup>154</sup> Whilst the case raises several contentious issues, for the moment we will simply note he adduced evidence of his authorship and sale of books on equestrian activities. Four years later, another horse trainer, Bob Avila, similarly established common law trademark rights in <bobavila.com>.<sup>155</sup> Whilst the case involved many hotly disputed cases of facts, Bob Avila clearly had common law trademarks due to the sale of books. We will later discuss the *Hillary Clinton Case* where again the complainant relied on the sale of books to establish common law trademark rights in a domain name.

One of the early cases where unregistered trademark rights were accepted without much argument concerned Herbert von Karajan.<sup>156</sup> Whilst Herbert von Karajan was a famous orchestral conductor he was not found to have common law trademark rights in his own name. This was because the respondent showed he had used the domain name for many years prior to the dispute and thereby had a right or legitimate interest in the domain name.

Several journalists have also successfully established common law trademarks in their own names.<sup>157</sup> Dan Marino is one such journalist.<sup>158</sup> For 17 years he was the quarterback for the Miami Dolphins, and had been a sports commentator. He also acted in movies, had his own television show and had been recognised for community service. The panel held the name

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<sup>149</sup> *Ibid.*

<sup>150</sup> *George Harrison v LOVEARTH.net*, NAF Case No FA0097085.

<sup>151</sup> *MPL Communications, Limited and MPL Communications, Inc v LOVEARTH.net*, NAF Claim No FA0097086.

<sup>152</sup> *MPL Communications, Limited et al v IWebAddress.com*, NAF Case Claim FA0097092.

<sup>153</sup> *Jagger v Hammerton*, FA 95261 (Nat Arb Forum, 11 September 2000).

<sup>154</sup> 'The Horse Whisperer': *Monty and Pat Roberts, Inc v Bill Keith*, WIPO Case No D2000-0299 (9 June 2000).

<sup>155</sup> *Bob Avila v B&B Productions*, WIPO Case No D2004-0013.

<sup>156</sup> *Dr Werner Kupper [Executor of the Estate of The late Herbert von Karajan] and Eliette von Karajan v Karajan Pty Ltd*, WIPO Case No D2000-1578.

<sup>157</sup> *Bernardo Neustadt v Link Commercial Corp*, WIPO Case No D2000-1256; *Lynne Russell v Kenneth Young*, WIPO Case No D2002-1133.

<sup>158</sup> *Daniel C Marino, Jr v Video Images Productions*, WIPO Case No D2000-0598.

‘Marino’ had acquired sufficient secondary meaning within the American sports, entertainment and public service communities to constitute a valid common law trademark.

A more recent example of a journalist who established common law trademark rights in the disputed domain name, concerned Maria Bartiromo.<sup>159</sup> She was a leading finance journalist of long standing in the United States. She was the anchor of CNBC’s ‘Closing Bell with Maria Bartiromo’ and a widely-syndicated commentator. Also, the domain name had not been used which indicated the respondent had opportunistically registered it. The panel therefore decided the respondent had no right or legitimate interest in the domain name and had acted in bad faith.

News announcers and radio personality cases are often similar to those which involve journalists. For example, it has been held that Nick Carter<sup>160</sup> has common law trademarks in his own names as he is:

... a popular and well-known on-air personality (i.e., DJ) at WBCN-FM (104.1), a radio station in Boston, Massachusetts. WBCN is the top-ranked alternative or ‘modern’ rock station in the Boston market. Complainant has been in the radio broadcasting business for many years.<sup>161</sup>

#### **b. Who has the Common Law Trademark?**

Whereas most celebrities are self-employed, journalists and those in similar occupations are often an employee, which has given rise to an interesting question. Who has common law trademark rights to bring a domain name complaint to the UDRP: the employer, employee or both?

In two separate 2003 cases,<sup>162</sup> the panel accepted Greta Van Susteran had assigned her common law trademark rights to the respondent, Fox News Network LLC (Fox). In the later case, the panellist explained this was because:

The Respondent accepts that the program is broadcast by the Complainant throughout the United States and also in Europe. Because of the wide publication of the name of the program, and the relatively ‘instant’ effect of television communications into some millions of homes, the panel is prepared to accept that the complainant has acquired common law service mark rights in the name of the program viz ‘On the Record with Greta Van Susteran’

...

Clearly employers can bring complaints to the UDRP which concern domain names of their employees. Fox has subsequently brought other domain name disputes to the UDRP as a complainant.<sup>163</sup> It is less clear whether news anchors retain their right to bring a domain name complaint to the UDRP in their own right. It has been suggested that news anchors, such as Larry King<sup>164</sup> and Tucker Carlson,<sup>165</sup> may retain common law rights in their own names. An

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<sup>159</sup> *Maria Bartiromo v ‘Maria Bartiromo’ and Dave Walton*, WIPO Case No D200-0242.

<sup>160</sup> *Nik Carter v The Afternoon Fiasco*, WIPO Case No D2000-0658.

<sup>161</sup> *Ibid.*

<sup>162</sup> *Fox News Network, LLC v Pro-Life Domains Inc*, WIPO Case No D2003-0335; *Fox News Network, LLC v Kenneth A Young*, WIPO Case No D2003-0407.

<sup>163</sup> *Fox News Network, LLC v C&D International Ltd and Whois Privacy Protection Service*, WIPO Case No D2004-0108.

<sup>164</sup> *Larry King v Alberta Hot Rods*, WIPO Case No D2005-0570.

<sup>165</sup> *Tucker Carlson v Domain Privacy Ltd*, WIPO Case No D2008-0474.

interesting exception is the case where the manager of the Formula 1 driver Giancarlo Fisichella was found to exclusively own the domain name <giancarlofisichella.com>.<sup>166</sup>

### c. How Famous Must the Celebrity Be?

It is also worth noting, complainants who are not house-hold names like Madonna might successfully claim an unregistered trademark in their own name. They may simply find it more difficult to prove they have common law trademark rights. One panellist has suggested the evidence required is in inverse proportion to the fame of the individual concerned.<sup>167</sup> However, personalities relatively unknown to the world at large may succeed if they are famous in their own field. Mr Richard Juzwin is such a celebrity, well known only in international stamp collection.<sup>168</sup> When a rival stamp dealer without authority registered the domain name <richardjuzwin.com> Mr Juzwin brought a claim to the UDRP. It was a clear case of deception to attract internet users to the domain name and then siphon them off to a rival business. The panel had no trouble finding that Mr Juzwin had established an unregistered trademark in his own name and it is appropriate that he won.

The principle that an individual may make out a common law trademark in his or her own name to get a UDRP application off the ground has also been applied to sports people.<sup>169</sup> Such successful complainants include the United States footballer Terrell Eldorado Owens,<sup>170</sup> the Williams sisters,<sup>171</sup> and the boxer George Foreman.<sup>172</sup> Two such sports cases include particularly insightful commentary of the burden of proof to establish common law trademarks.<sup>173</sup>

A particularly interesting sports case, because of its helpful commentary on the burden and standard of proof to be applied in establishing a common law trademark, is one we have already noted for another purpose: *Fox News Network, LLC v C&D International Ltd and Whois Privacy Protection Service*.<sup>174</sup> Also, one could note here, on the question of whether the evidence being submitted is sufficient or not, the decision in *Nat'l Ass'n of Prof'l Baseball Leagues v Zuccarini*.<sup>175</sup>

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<sup>166</sup> *Giampaolo Matteucci v Webmaster, AWG*, WIPO Case No D2001-1135.

<sup>167</sup> *Fox News Network, LLC v C&D International Ltd and Whois Privacy Protection Service*, WIPO Case No D2004-0108.

<sup>168</sup> *Richard Juzwin v Glen Stephens Stamps*, NAF Case No FA0106000097690.

<sup>169</sup> *Mr Severiano Ballesteros Sota, Fairway, SA and Amen Corner, SA v Patrick Waldron*, WIPO Case No D2001-0351; *Xavier Hernández Creus v Isidro Sentis Sales*, WIPO Case No D2001-0710; *Juventus FC SpA v Vincent Khouw*, WIPO Case No D2001-0844; *Francesco Totti v Jello Master*, WIPO Case No D2002-0134; *Giampaolo Matteucci v Webmaster, AWG*, WIPO Case No D2001-1135; *Michael James Owen v MSM Commercial Services*, WIPO Case No D2006-0155; *Jules I Kendall v Donald Mayer Re skipkendall.com*, WIPO Case No D2000-0868.

<sup>170</sup> *Terrell Eldorado Owens v Aran Smith d/b/a Sportsphenoms.com and/or Sportsphenoms*, WIPO Case No D2003-0463.

<sup>171</sup> *Serena Williams and Venus Williams v Eileen White Byrne and Allgolfconsultancy*, WIPO Case No D2000-1673.

<sup>172</sup> *George Foreman Ventures LLC v zinnia c/o Zinnia Gonzalez*, NAF Case No FA0599036.

<sup>173</sup> *Fox News Network, LLC v C&D International Ltd and Whois Privacy Protection Service*, WIPO Case No D2004-0108; *Nat'l Ass'n of Prof'l Baseball Leagues v Zuccarini*, WIPO Case No D2002-1011.

<sup>174</sup> WIPO Case No D2004-0108.

<sup>175</sup> WIPO Case No D2002-1011.

#### d. Trying to Disprove the Common Law Trademark

It is always interesting to consider the grounds on which respondents have attempted to deny common law trademarks. Take for instance a 2004 case which concerned the song writer and high priestess of Kitsch, Allee Willis.<sup>176</sup> Among her best-known compositions is ‘I’ll Be There for You’, the theme song of the very well known and long running ‘Friends’ television series. The respondent, who had registered the domain name <alleewillis.com> and who you would think would be above this sort of argument, denied that Ms Willis was well known or famous. According to him, ‘[e]xcept for her inside crowd and some trivia fanatics, no one knows who Allee Willis is, whereby no common law trademark could exist’. He accordingly argued she could not have common law trademark rights in her own name. One might wonder why he registered the domain name of Allee Willis if she was not really a celebrity. In any event, it was held that Ms Willis had common law trademark rights because she had used the name extensively for commercial purposes.

It is worth reiterating that good evidence is needed to satisfy the panel that a celebrity has common law trademark rights. Evidence must be adduced not only of the complainant’s celebrity status, but that his or her name is associated with goods and services in a commercial way.

Two cases which failed to establish that the celebrity’s name had commercial implications involved evangelical church leaders, the late Reverend Dr Jerry Fallwell<sup>177</sup> and Gene Edwards.<sup>178</sup> In both cases the panel noted there was a lack of evidence that the evangelical church leader concerned had used his name in writing or television appearances to make money. However, in the case which concerned Gene Edwards the panel provided a ray of hope for future religious complainants. The panel suggested that a minister could establish common law trademark rights if there is adequate evidence he had used his name in commerce. This appears to be supported by the case law. The religious leader Vernon Howard successfully established common law trademark rights in his own name.<sup>179</sup> It has also been suggested that gurus and yogis can similarly establish common law trademarks if adequate evidence is adduced.<sup>180</sup>

Similar to the two evangelical church leaders discussed above, many complainant politicians have failed to establish that their name is associated with commercial goods and services. These cases strongly indicate it is crucial that the complainant adduces evidence of the commercial use of their name. However, there have also been some odd cases where the panel have not mentioned any requisite commercial aspect.

One such odd case is the 2000 *Anne McLellan Case*<sup>181</sup> where the said politician successfully established common law trademark rights to the domain names <annemclellan.com> and <annemclellan.org>. The panel found she had common law rights in her name as a Member of Parliament, the Minister of Justice and Attorney-General of Canada. The panel noted she

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<sup>176</sup> *Allee Willis v NetHollywood*, WIPO Case No D2004-1030.

<sup>177</sup> *The Reverend Dr Jerry Falwell and The Liberty Alliance v Gary Cohn, Prolife.net, and God.info*, WIPO Case No D2002-0184.

<sup>178</sup> *Gene Edwards v David Miller*, WIPO Case No D2003-0339.

<sup>179</sup> *New Life Church and Literary Foundation v Private Business a/k/a Virgil Howard*, NAF Case No FA00096280.

<sup>180</sup> *Chinmoy Kumar Ghose v ICDSOFT.com and Maria Sliwa*, WIPO Case No D2003-0248.

<sup>181</sup> *Anne McLellan v Smartcanuk.com*, AF-0303 (eResolution Case, 25 September 2000).

was well known in Canada and was the ‘... most senior Government of Canada official in the Province of Alberta ...’ but did not mention any commercial use of her name. Interestingly, in 2001 a United States political candidate, Mark Warner, was also found to have common law rights in his own name.<sup>182</sup> Whilst he certainly had less prominent political status, in both these cases the panel did not mention any requisite commercial requirement. These two cases are at odds with the generally accepted line of argument in later cases.

Most cases have required politicians to have commercially used their name to have acquired common law trademark rights in it. For example, in 2002 Ms Kennedy Townsend failed to establish common law trademark rights as a public figure and daughter of the late Senator Robert Kennedy.<sup>183</sup> In the *Ms Kennedy Townsend Case* the panel stated:

The Panel finds that the protection of an individual politician’s name, no matter how famous, is outside the scope of the Policy since it is not connected with commercial exploitation as set out in the Second WIPO Report.

The panel distinguished Ms Townsend from a legal fund-raising entity which would have the requisite element of commerciality. It also explained it had not followed the *Anne McLellan Case* because of the recommendations in the Second WIPO Report issued in 2001. That report strongly recommended the ‘[p]olicy should be limited to personal names that had been commercially exploited’. The panel thereby concluded that if the decision in the *Anne McLellan Case* was not wrong, it certainly had been overtaken by subsequent events. The *Ms Kennedy Townsend Case* was followed a year later when a spokesperson for freedom of reproductive choice failed to establish common law trademark rights in her name.<sup>184</sup> Whilst the panel noted Gloria Felt’s reputation was admirable, she had not used her name for a sufficiently commercial purpose.

The *Ms Kennedy Townsend Case* and the *Gloria Feldt Case* indicate public figures may fail to establish common law trademark rights if they have not commercially used their names. However, these cases were followed by an interesting and instructive decision in the *Hillary Rodham Clinton Case*.<sup>185</sup> Like some other celebrities, Senator Clinton was able to establish a trademark in her own name. She was and is famous, a senator and the wife of a former United States President. However, it was her big sales of several books which lead to the finding her name was associated with trade and commerce.

These three cases strongly indicate a complainant to the UDRP must prove their name has commercial implications to establish common law trademark rights. The politician Mark Partridge also failed to establish common law trademark rights. A note on his case cites a similar case where the defendant registered a domain name to provide summaries of news stories during Robin Flicker’s run for Congress.<sup>186</sup> Again, the complainant was denied common law trademark rights for reasons which included that the website was used only for political purposes. Similarly, in a 2006 case another politician, Virginia Fields, was denied

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<sup>182</sup> *Mark Warner 2001 v Mike Larson*, NAF Case No 95746 .

<sup>183</sup> *Kathleen Kennedy Townsend v B G Birt*, WIPO Case No D2002-0030.

<sup>184</sup> *Planned Parenthood Federation of America, Inc and Gloria Feldt v Chris Hoffman*, WIPO Case No D2002-1073.

<sup>185</sup> *Hillary Rodham Clinton v Michelle Dinoia a/k/a SZK.com*, NAF Case No FA0414641.

<sup>186</sup> The note is from <[http://www.circleid.com/posts/personal\\_names\\_politics\\_and\\_cybersquatting](http://www.circleid.com/posts/personal_names_politics_and_cybersquatting)> and cites the case *Robin KA Flicker v John W Thouhy*, 305 F Supp 2d 569 (DMd 2004).

common law trademark rights in the domain names in contention.<sup>187</sup> Again, her claim failed because there was no evidence she had used her name in commerce or as a source of goods or services. These cases strongly suggest politicians must have commercially used their name to establish common law trademark rights. However, the earlier *Anne McLellan Case* and the case which concerned Mark Warner still raise some doubt over the commercial requirement.

#### e. The Importance of Evidence

Clearly, cases must be carefully prepared and it is very important that all available evidence is adduced before any case is submitted. Potential complainants risk that their case will fail and conversely respondents may lose their trademark rights to a domain name. The following discussion will illustrate why parties, particularly complainants, should not risk failure due to a lack of evidence.

A very well known person does not necessarily acquire common law trademark rights in their personal name. For example, one complainant failed to establish common law trademark rights to the name Dr Albert Einstein because the panel had no evidence ‘... that Dr Einstein used his name for commercial purposes during his lifetime nor that his name, famous though it was, became identified as a source of goods or services’.<sup>188</sup> However, the complainant could establish trademark rights to the name Dr Albert Einstein because a French trademark existed.

This raises the interesting question of whether the Pope has acquired common law trademark rights. Before the election of the current Pope, an enterprising journalist registered the domain name <bendictxvi.com> and donated it to the Vatican after the election. Other people have not been so generous. Someone registered <benedict16.com> and <popebenedict16.com> and offered them for sale on eBay. Could the Vatican claim it has a trademark on the name of the Pope? Would the Vatican dare to claim the Pope is in trade or commerce? Interestingly, there has already been a case which concerned the domain name <vaticanlibrary.com>.<sup>189</sup>

Often the success of a case depends on what evidence panellists expect to be provided with. In *Patti LuPone v XC2/Moniker Online Services LLC*<sup>190</sup> there was little evidence the singer and actress Patti LuPone had acquired common law trademark rights in her name. Despite the absence of hard evidence the complainant succeeded. This can be compared to a case which concerned the formerly successful Australian businessman Alan Bond.<sup>191</sup> The panel found the complainant’s assertions of his business achievements were insufficient to establish common law trademark rights. They said they had ‘... not been provided with relevant hard evidence to enable the panel to make the assessment [on trademark rights]’. This author can personally attest to the difficulty of determining whether there is sufficient evidence of common law trademark rights.<sup>192</sup>

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<sup>187</sup> *Fields for Senate v Toddles Inc*, WIPO Case No D2006-1510.

<sup>188</sup> *The Hebrew University of Jerusalem v Alberta Hot Rods*, WIPO Case No D2002-0616 .

<sup>189</sup> *1451 International Ltd and Second Renaissance, LLC v Steven Levine, c/o DomainSystems, Inc*, NAF Case No FA0583774.

<sup>190</sup> WIPO Case No D2008-0450.

<sup>191</sup> *Alan Bond v Information360 Limited*, WIPO Case No D2007-1081.

<sup>192</sup> One such borderline case was *Cedric Kyles v Domains by Proxy, Inc /Asia Ventures, Inc*, WIPO Case No D2006-0046.

If an appointed panellist is not provided with evidence he or she expects and the complainant's claim is rejected, the consequences can be disastrous. The *David Pecker Case*<sup>193</sup> is a classic example of the harsh consequences of a rejected claim due to a lack of evidence. The strong view of this author is that potential complainants should adduce all available evidence in the proper manner. All parties should provide certified copies of relevant documents and statutory declarations or affidavits to support any claims or defences made.

Many business people have found it difficult to establish common law trademark rights. Their trade or commercial activity is likely to have been carried out under a company or product name, rather than in their own. Therefore, such business people may find it hard to establish their personal name, not the company name, should attract trademark rights.<sup>194</sup> This is especially so when the personal name is not the alter ego of the company.

Some well known business people have been found to be insufficiently associated with trade and commerce to have common law trademark rights to their names. For example, the well known Canadian media mogul and philanthropist Israel Asper was found to have done good charitable works.<sup>195</sup> However, the panel denied trademark rights as his name had not been associated with trade and commerce. Mr Asper's son, Leonard Asper, was similarly denied common law trademark rights to his name.<sup>196</sup> The panel found Leonard Asper had never used or intended to use his name to commercially promote goods or services.

Common law trademarks have also been denied when the individual concerned is deceased and the will does not specify the inheritance of a trademark. This was illustrated in the previously discussed *Dr Albert Einstein Case*. In that case the panel would not find common law trademark rights as there was no mention of a trademark in Einstein's will. This can be distinguished from a case where a company has used the name of its now deceased founder in trade and commerce. For example, Wal-Mart Stores Incorporated established common law trademark rights to the name 'Sam Walton' because it had used it in trade.<sup>197</sup>

Despite the difficulties, some businessmen have established a common law trademark in their own name which is not the alter ego of the company or product.<sup>198</sup> In contrast to Israel and Leonard Asper, the media mogul Barry Diller was found to have common law trademark rights in his own name.<sup>199</sup> In fact, in some cases panels have found business people have common law trademarks when some might say the evidence was not strong enough.<sup>200</sup>

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<sup>193</sup> WIPO Case No D2006-1514.

<sup>194</sup> *Kotak Mahindra Bank Limited v Richard Brown*, WIPO Case No D2008-0243.

<sup>195</sup> *Israel Harold Asper v Communication X Inc*, WIPO Case No D2001-0540.

<sup>196</sup> *Leonard Asper in Leonard Asper v Communication X Inc*, WIPO Case No D2001-0539.

<sup>197</sup> *Wal-Mart Stores, Inc and Mrs Helen Walton v Bestinfo/David Webb*, WIPO Case No D2005-0086.

<sup>198</sup> *Steven Rattner v BuyThisDomainName (John Pepin)*, WIPO Case No D2000-0402; *Chung, Mong Koo v Individual*, WIPO Case No D2005-1068, followed in *Soin International LLC v Michael W Solley, PrivateRegContact Admin/TECH*, WIPO Case No D2007-0094, and endorsed in *Kotak Mahindra Bank Limited v Richard Brown*, WIPO Case No D2008-0243. See the discussion of this decision in Lindsay, *International Domain Name Law ICANN and the UDRP* (2007) 220–1.

<sup>199</sup> *Barry Diller v INTERNETCO CORP*, WIPO Case No D2000-1734.

<sup>200</sup> One such example is *Film Council v Boolean Consulting Limited*, AF-0503 (eResolution Case).

In *UBS AG v has book publishers, Inc*<sup>201</sup> an interesting distinction was made between the trademark rights of a bank and its chairman and CEO. The case involved two domain names: <ubs-privatebanking.com> (D2001-0637) and <marcelospel.com> (D2001-0639). Mr Ospel was the Chairman and the former CEO of the bank. Both websites were used to air allegations of money laundering and corruption by the bank for which it was said Mr Ospel was responsible. The bank had registered trademarks on UBS and similar expressions, and the panel found that the first domain name was confusingly similar to those marks. However, the panel also found that the only complainant, the bank, could not complain about the domain name in Mr Ospel's name.

Some business people can succeed, on appropriate evidence, as did Philip Berber in *Philip Berber v Karl Flanagan and KP Enterprises*.<sup>202</sup> Mr Berber had received worldwide publicity when the online trading brokerage firm that he founded was sold to Charles Schwab & Co for US\$488 million. He established common law rights in his name because, as the panel put it:

The Complainant is a well known businessman. The press reports surrounding the success of his business show that he has a significant reputation in the field of electronic trading of stocks over the Internet. Were anyone to try to set up an electronic stock trading business or to offer software related to this field no doubt Mr Berber would have an arguable case in passing off.

However, it should not be surprising that business people have also lost such claims. Examples of such unsuccessful business people include Joacim Bruus-Jensen,<sup>203</sup> Marvin Lundy<sup>204</sup> and David Pecker.<sup>205</sup> In at least one case, the panel found the complainant had common law rights after expressly finding there was no evidence from the complainant to that effect.<sup>206</sup> The panel could so conclude on the evidence of the respondent. The basis for this approach was the complainant claimed to be and the respondent affirmed that he was, a distinguished international academic scholar.

A more recent loss was suffered by Birgit Rausing, one of the Rausing (Tetra Pak) family who was also an author.<sup>207</sup> The panel held she needed to have written more books and acquired real fame to acquire trademark rights. Apparently it was not enough to be an author of three books. Recall in the *Hillary Clinton Case*, the complainant won on the ground that she had written books for which she had been paid. Interestingly, the panellist in the *Hillary Clinton Case* did not adopt the notion of a sliding scale. Such a scale would suggest only the upper echelons of authors, based on the number of books they had written, would have common law trademark rights in their own names.

Currently, a complainant may establish unregistered trademark rights based on an individual name and therefore succeed in the claim. However, the facts and the evidence adduced to support them will determine the outcome of any given case.

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<sup>201</sup> WIPO Cases Nos D2001-0637, D2001-0639.

<sup>202</sup> WIPO Case No D2000-0661.

<sup>203</sup> *Joacim Bruus-Jensen v John Adamsen*, WIPO Case No D2004-0458.

<sup>204</sup> *Marvin Lundy and Law Offices of Marvin Lundy, LLP v Scott E Idmaond (Scott E Diamond)*, WIPO Case No D2001-1327.

<sup>205</sup> *David Pecker v Mr Ferris*, WIPO Case No D2006-1514.

<sup>206</sup> *Geert Hofstede v Sigma Two*, WIPO Case No D2003-0646.

<sup>207</sup> *Birgit Rausing, AB Tetra Pak v Darren Morgan*, WIPO Case No D2008-0212.

#### f. The Further Requirement: Confusingly Similar

Remember that if a common law trademark is established the celebrity must still show it is identical or confusingly similar to the disputed domain name. For example, in one case the panel decided the domain name <pornrtrumps.com> was not confusingly similar to the TRUMP trademark.<sup>208</sup> The panel decided readers would not associate it with Donald Trump, but with the notion that pornography succeeds or is paramount. Similarly, it has been held the domain name <trumpfurniture.com> would not be necessarily assumed to be the business of Mr Trump.<sup>209</sup> However, in many cases celebrities will be able to prove the domain name is confusingly similar to the trademark. This is especially so when the respondent registered the domain name to make it appear 'official'. For example, in one case it was probably no coincidence the respondent registered the domain name <lisacurren.com> as well as the similarly spelt <lisacurrenswim.com>.<sup>210</sup>

Domain names can still be confusingly similar to trademarks when they contain an additional word. For example, one panel held the domain name <startrekarmada.com> was confusingly similar to the STARTREK trademark.<sup>211</sup> The panel stated:

Appending the phrase 'armada' or 'armada2' to the mark does not signify a different field of use, unlike appending the phrase 'travel' to the mark 'CITI', which is best known in conjunction with financial services.

Similarly, a panel has held the domain name <stonesconcerts.com> is confusingly similar to THE STONES trademark.<sup>212</sup> Also, it has been found that the addition of the word 'enterprises' to the trademark name 'George Foreman' was confusingly similar.<sup>213</sup> *WOW Audio Visual Superstores Pty Ltd v Comonoz Pty Ltd* is another example of the same problem in the context of the Australian country code '.com.au'.<sup>214</sup>

#### g. Procedural Issues

Trademark rights must exist at the time of making the complaint. This is taken to mean at the time of filing of the complaint.<sup>215</sup> However, the need for the trademark to exist at that particular time has been criticised in *Bruce Springsteen v Jeff Burgar and Bruce Springsteen Club*.<sup>216</sup>

It probably goes without saying, but care must be taken to ensure that the right party is designated as the complainant. Clearly, the right party is the one who is entitled to the common law trademark rights and entitled to take action to protect them.

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<sup>208</sup> *Donald J Trump and Trump Hotel & Casino Resorts, Inc v olegevtushenko a/k/a Oleg Evtushenko*, NAF Claim No FA0110000101509.

<sup>209</sup> *Donald J Trump v eStore of New York*, WIPO Case No D2007-0119.

<sup>210</sup> *Gaetano, Inc d/b/a Lisa Curran Swim v Texas International Property Associates*, WIPO Case No D2007-1428.

<sup>211</sup> *Startrek Paramount Pictures Corporation v Buy This Domain aka Domains Best Domains*, WIPO Case No D2003-0058.

<sup>212</sup> *Rolling Stones Case, Musidor BV v Phil K*, NAF Case No FA0602000648140.

<sup>213</sup> *George Foreman Ventures LLC v zinnia c/o Zinnia Gonzalez*, NAF Case No FA0599036.

<sup>214</sup> WIPO Case No DAU2007-0003.

<sup>215</sup> *R E 'Ted' Turner and Ted Turner Film Properties, LLC v Mazen Fahmi*, WIPO Case No D2002-0251.

<sup>216</sup> WIPO Case No D2000-1532.

One case where this could have been an issue was *Gene Kelly Image Trust v BWI Domain Manage*,<sup>217</sup> where it seems the panel found that a trust was the correct complainant. The panel observed that:

The rights in this mark were transferred to the Complainant upon Gene Kelly's death in 1996 pursuant to the Declaration of Trust. The panel therefore finds that the 'Gene Kelly' name and trademark is still used substantially in trade to promote his performance services.

### **35. 5. The Next Step: Rights or Legitimate Interests**

Let us assume a celebrity complainant has established a trademark, rights to it and that the domain name at issue is identical or confusingly similar to the trademark. We may then confidently expect the panellist who considers the claim will find this celebrity has established the first of the three requisite elements to make out the claim. Like any other complainant, a celebrity complainant in UDRP proceedings has to prove the remaining two elements under para 4 of the policy to succeed. We will now examine the second element: that the complainant has rights or a legitimate interest in the name.

#### **lxiv. Rights or Legitimate Interests**

As we have seen, the three elements that must be proven before a complainant can succeed are:

- (1) the domain name is identical or confusingly similar to a trademark or service mark in which the complainants have rights; and
- (2) the respondent has no rights or legitimate interests in respect of the domain name; and
- (3) the domain name has been registered and is being used in bad faith.

Under para 4(c) of the policy and by way of defence to the claim, the respondent may establish its rights or legitimate interests in a domain name. Among other circumstances, the respondent may do this if he or she shows any of the following elements:

- a) before any notice to you [Respondent, who registered the domain name] of the dispute, your use of, or demonstrable preparations to use, the domain name or a name corresponding to the domain name in connection with a bona fide offering of goods or services; or
- b) you [Respondent] (as an individual, business, or other organization) have been commonly known by the domain name, even if you have acquired no trademark or service mark rights; or
- c) you [Respondent] are making a legitimate non-commercial or fair use of the domain name, without intent for commercial gain to misleadingly divert consumers or to tarnish the trademark or service mark at issue.

The use of the expression, 'among other circumstances' in the introductory words is important. This expression indicates the party who is under challenge can defend the domain name they registered on grounds other than in para 4(c). Respondents may of course also rely

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<sup>217</sup> WIPO Case No D2008-0342.

on one of the three criteria in para 4(c). If a respondent proves a legitimate interest in the domain name, the complainant will have failed to discharge its onus and their claim will fail.

However, it is often difficult for the complainant to discharge that onus. He or she has to prove a negative, which may as well be impossible. All that the complainant may know is that his or her name has been taken and used in a domain name. He or she may find who has registered the domain name and look at the website the domain name is linked to. However, the complainant may be otherwise in the dark.

Accordingly, in practice the complainant initially must only *prima facie* prove the respondent has no right or legitimate interest in the domain name. Then the onus moves to the respondent to rebut the *prima facie* case. If the respondent does not do so, the complainant is taken to have proved it. This is set out in para 2.1 of the valuable *Overview of WIPO Panel Views on Selected UDRP Questions*.<sup>218</sup>

#### **h. Bona Fide Offering of Goods or Services**

Some respondents have defended claims under sub-para (i) of the policy when the domain name was used as an email address service or to advertise products. However, if a respondent appears to be profiting from the complainant's good name, the panel would probably not find a legitimate interest. This would include situations where the respondent offers generic brands of the complainant's products or has diverted hits from the complainant's site.

The previously discussed *Dr Albert Einstein Case*<sup>219</sup> provides a good example of a respondent who showed a right or legitimate interest in a domain name under para (c)(i) of the policy. The domain name at issue was <alberteinstein.com> and was linked to <celebrity1000.com> which provided information about many celebrities. The panel's explanation for its finding that the respondent had a legitimate interest in the domain name is as follows:

Dr. Einstein died long before the advent of the Internet and was not in his lifetime engaged in the supply of goods or services under his name. This Panel finds that what Internauts are seeking when they enter the disputed domain name is information about Dr. Einstein. That is precisely what Respondent's site <celebrity1000.com> contains. Accordingly, it was not misleading for Respondent to select and use the disputed domain name to lead to that site nor, for the above reasons, does the use of the disputed domain name for this purpose tarnish complainant's trademark.

#### **i. Respondent Commonly Known by the Domain Name**

A few respondents have had the foresight to register their own names as domains before domain name disputes arose. Their early registrations have assisted them to argue they were 'commonly known' by the domain name as described by sub-para (ii). However, it would be an incorrect application of the policy to assume an early registration meant the respondent was 'commonly known' by the domain name. Such an assumption would make the inclusion of sub-para (ii) in the policy meaningless. The respondent must prove their name became understood as the disputed domain name.

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<sup>218</sup> WIPO: see <<http://www.wipo.int>> and follow the links to the Overview.

<sup>219</sup> *The Hebrew University of Jerusalem v Alberta Hot Rods*, WIPO Case No D2002-0616.

Some respondents have simply been lucky that commercial companies have sought domain names which happen to be their family name. For example, in one case the respondent was able to show his full name was A R Mani.<sup>220</sup> He was thereby lucky enough to have domain name rights to <armani.com>. Then there was the equally lucky Maggi family whose name was naturally coveted by the Nestle Company.<sup>221</sup> The family was able to show their name was Maggi and so, like Mr A R Mani, they had domain name rights to <maggi.com>. It appears from the current websites that after the Armani Company and Nestle lost they were both obliged to buy the respective domain names.

Such cases are really a matter of fact to be decided one way or the other. The argument that the respondent was commonly known by the domain name was unsuccessful in *Peter Frampton v Frampton Enterprises, Inc.*,<sup>222</sup> but successful in *Weider Publications Inc v Don Ho Cha.*<sup>223</sup> The latter decision is particularly significant as the domain name was <musclenfitness.com> rather than a given or family name.

#### j. **Legitimate Non-Commercial or Fair Use of the Domain Name**

Cases are often hotly debated if the respondent alleges a legitimate non-commercial or fair use of the domain name under sub-para (iii). If the domain name is being used for a strictly non-commercial criticism site it may be a legitimate exercise of free speech. Then the alleged transgressor may end up keeping the domain name.

Again the *Dr Albert Einstein Case*<sup>224</sup> rears its head, this time as a good example of a panel finding the respondent had a legitimate fair use of the disputed domain name as described in sub-para (iii). The panel found the respondent did not intend to commercially gain from, misleadingly divert consumers from or tarnish the complainant's French registered trademark ALBERT EINSTEIN. The panel found this because the <celebrity1000.com> site, to which hits on <alberteinstein.com> were directed, provided information on Albert Einstein. The respondent had not misled people as people would expect the site to give information on Einstein. A case was made out for sub-para (iii) despite that the <celebrity1000.com> site had links to offerings of goods and services like <amazon.com>.

Complainants and respondents to domain disputes must raise the same elements or defences regardless of whether either party is a celebrity. If a respondent uses the domain name for pornography he or she will probably lose rights to that domain name.<sup>225</sup> The celebrity complainant would probably easily establish pornography was not a legitimate interest in the domain name.

#### lxv. **The General Test**

The general test of what is required to show that the respondent did not have a right or legitimate interest in the domain name was given in *Richard Juzwin v Glen Stephens*

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<sup>220</sup> *G A Modefine SA v A R Mani*, WIPO Case No D2001-0537.

<sup>221</sup> *Societe des Produits Nestle SA v Pro Fiducia Treuhand AG*, WIPO Case No D2001-0916.

<sup>222</sup> WIPO Case No D2002-0141.

<sup>223</sup> WIPO Case No D2001-0105.

<sup>224</sup> *The Hebrew University of Jerusalem v Alberta Hot Rods*, WIPO Case No D2002-0616.

<sup>225</sup> *A & F Trademark, Inc, Abercrombie & Fitch Stores, Inc, Abercrombie & Fitch Trading Co, Inc v Party Night, Inc*, WIPO Case No D2003-0172.

*Stamps*.<sup>226</sup> In that case the panel found the '[r]espondent uses the <richardjuzwin.com> domain name to resolve to its own competing website. It is firmly established that such a use does not constitute a bona fide offering of goods or services ...'.

Then the panel considered whether the respondent had a legitimate interest in the domain name. They considered whether the respondent had adduced sufficient evidence of a legitimate interest in the domain name. Conversely, they also considered whether the complainant had shown the domain name had been inappropriately used. In some cases the complainant has shown the respondent has no right or legitimate interest in the domain name. In others, the respondent has successfully shown a right or legitimate interest in the domain name.

We will look at some cases on each side of that divide. Some are clear illustrations of one of the sub-paragraphs of the policy. In others, the panel has been influenced by a more general notion of right or legitimate interest than the sub-paragraphs.

#### **k. Cases Where the Respondent has Failed to Prove a Right or Legitimate Interest in the Domain Name**

Most respondents who fail to prove a right or legitimate interest in the disputed domain name clearly intended to purloin the famous person's name and make money. For example, in the *Nicole Kidman Case*<sup>227</sup> the panel decided that the respondent had no right or legitimate interest in <nicholekidman.com> or <nicolekidmannude.com>. This was partly because Nicole Kidman had made out a *prima facie* case, but Mr Zuccerini also had a reputation as a cybersquatter. There are a number of other cases where it is virtually impossible to provide a legitimate explanation of why the domain name was registered.

Another example is *Barry Diller v INTERNETCO CORP*.<sup>228</sup> Barry Diller easily established common law rights in his own name because he owned companies and acted as an office bearer in them. The domain names were linked to a pornography site and there had been thinly-veiled offers by the respondent to sell them. The panel could clearly see the respondent had no right or legitimate interest in the domain names.

In a more recent case the obviously unprincipled conduct of the respondent made it easy for the complainant to make her case. In the *Kendra Todd Case (supra)* the respondent used the website to display false information regarding Ms Todd, a former business partner. He attempted to use the disputed domain name as leverage to collect money from her. Additionally, he attempted to sell the <kendratodd.com> domain name to the complainant. The panel found that 'these actions demonstrate that respondent is not using the disputed domain name for either a bona fide offering of goods or services under policy ¶ 4(c)(i) or a legitimate non-commercial or fair use under policy ¶ 4(c)(iii)'. One could not but agree.

Further, if there is no plausible explanation for the registration of the disputed domain name, it almost guarantees a successful result for the celebrity complainant. In *Estate of Tupac*

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<sup>226</sup> NAF Case No FA0097690 (2001).

<sup>227</sup> *Nicole Kidman v John Zuccarini, d/b/a Cupcake Party*, WIPO Case No D2000-1415.

<sup>228</sup> WIPO Case No D2000-1734.

*Shakur v Shakur Info Page*,<sup>229</sup> where the domain name was <tupacshakur.org> the panel described the facts as follows:

Mr. Tupac Shakur, often known as 2Pac or Tupac, was an internationally known ‘Hip-Hop’ musician, actor and poet, murdered in 1996 at the age of 25.

On January 9, 2000 the contested domain name was registered in the name of the respondent. The name does not resolve to an active web site. However, the respondent’s registered email address, hiphopspot@hiphopspot.com provides an association between the respondent and the web site www.hiphopspot.com, which exploits Mr. Shakur’s recordings by offering for sale ‘bootleg’ and ‘unreleased’ 2Pac CDs.

The suggestion of commercial exploitation meant it would have been a monumental effort to show a right or legitimate interest in the domain name. Similarly, In *The Wiggles Touring Pty Ltd v Thompson Media Pty Ltd*,<sup>230</sup> the panel found the respondent had registered the domain names to sell them. Clearly, the respondent had no rights or legitimate interests in the domain names.

Whether a right or legitimate interest is proved or not can raise some interesting questions and fact situations in the celebrity context. In the *Madonna Case*, the respondent registered the domain name ‘Madonna’ and for a time used it for an explicit sex site. He argued that he had a right or legitimate interest in the domain name for several reasons. One was the adult entertainment site used to offer *bona fide* goods and services. The panel found the respondent had provided goods and services but the use of the name Madonna negated any notion of legitimacy. The panel found it was reasonably clear that the respondent had chosen the name Madonna to trade off the name of the famous entertainer. His conduct could scarcely be described as *bona fide*.

In the *Monty Roberts Case*<sup>231</sup> the respondent who had registered the domain name was also held not to have a right or legitimate interest in the domain name. Monty Roberts had already registered <montyroberts.com> and used it for his website. He was now challenging Bill Keith who had registered the domain name <montyroberts.net>. Mr Keith claimed he had a right or legitimate interest in the domain name on several grounds. One ground was he had used the domain name to stimulate debate and discussion. He claimed to have legitimately used the .net domain name ‘... to disseminate information about his perpetrating a fraud on the public’. In the ICANN Policy this is referred to as ‘legitimate non-commercial or fair use purposes’. Mr Keith ultimately failed to defend his trademark domain name rights, but the decision is important because it raised the issue of free speech on the internet.

The *Monty Roberts Case* established the exercise of free speech may give rise to a legitimate interest and thereby defeat a celebrity’s claim to the domain name. Mr Keith simply had not exercised free speech sufficiently to establish a legitimate interest. The panel made a distinction which has been referred to as the ‘New York Times principle’ or argument:

... the right to express one’s views is not the same as the right to use another’s name to identify one’s self as the source of those views. One may be perfectly free to express his or her views about the quality or characteristics of the reporting of the New York Times or Time

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<sup>229</sup> NAF Case No AF-0346.

<sup>230</sup> WIPO Case No D2000-0124.

<sup>231</sup> ‘*The Horse Whisperer*’ Case: *Monty and Pat Roberts, Inc v Bill Keith*, WIPO Case No D2000-0299.

Magazine. That does not, however, translate into a right to identify one's self as the New York Times or Time Magazine.

The panel applied this principle when it stated the respondent does not have 'the right to identify itself as Complainant'.

The New York Times principle has become a major issue of disputation in UDRP arbitration. A form of the same argument was used in *Leonard Asper Case, Leonard Asper v Communication X Inc.*<sup>232</sup> In this case the complainant's claim to the domain name was denied because he failed to establish a trademark existed. However, the complainant managed to disprove the right or legitimate interest defence. The panel described its conclusion on the right or legitimate interest issue as follows:

Previous Panel decisions have held that it is not appropriate to use the name of the entity whom one wishes to criticize on the basis of 'fair use' to divert Internet traffic to the site. See the Monty Roberts case, above, along with *Compagnie de Saint Gobain v Com-Union Corp*, WIPO Case No. D2000-0020 and *Ahmanson Land Company v Save Open Space and Electronic Imaging Systems*, WIPO Case No. D2000-0858.

The defence of rights or legitimate interests in a domain name has failed in a number of other cases. In *Fondation Le Corbusier v Mercado M*,<sup>233</sup> the respondent argued that there was a right or legitimate interest in the domain name because the website was a fan site. However, this argument failed because the respondent's site was made to look official and provided some commercial links. The respondent's website was not a pure fan site so it could not constitute a legitimate interest. Likewise, in the case of the Slovenian female motorcyclist, *Bernardka Pulko v Greg Frazier*,<sup>234</sup> the respondent failed to show a right or legitimate interest in the four domain names at issue. All these domain names incorporated Ms Pulko's name. Like in the *Monty Roberts Case* the incorporation of the trademark owner's name in the domain name was a determinative factor.

Often the respondent simply does not reply to the complainant's claim. The panel can draw 'appropriate' inferences from a respondent's failure to show their right or legitimate interest in a domain name.<sup>235</sup> Panellists often infer that the respondent had no right or legitimate interest otherwise he or she would have raised it. This was the case in *Dr Roger Libby v Tunga Tuzlaci and/or Tumay Asena*,<sup>236</sup> where the sex therapist Dr Roger Libby had let his domain name expire. The respondent quickly registered the domain name and offered to sell it back to Dr Roger Libby. The panel decided the respondent had no right or legitimate interest in the domain name as it could not think of one.

Despite the ability of the panel to make such 'appropriate' inferences, all assertions must be supported by evidence. The case concerning the pornography star Sylvie Saint certainly demonstrates the need for evidence to verify all assertions.<sup>237</sup> In *Pelé's Case* the respondent's assertions of a right or legitimate interest failed as they were not supported by any

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<sup>232</sup> WIPO Case No D2001-0539.

<sup>233</sup> WIPO Case No D2004-0723.

<sup>234</sup> WIPO Case No D2006-0099.

<sup>235</sup> Rules for Uniform Domain Name Dispute Resolution Policy, r 14(b).

<sup>236</sup> WIPO Case No D2001-1342.

<sup>237</sup> *Sylvie Tomalová aka Sylvia Saint v Juan Campos*, WIPO Case No D2006-0379.

evidence.<sup>238</sup> The panel gave the respondent a second chance to produce documentary evidence which would have existed if what the respondent had said was true. When the respondent did not produce any evidence to that effect, the panel concluded:

In the face of Pele's letter and in the absence of any explanation from the Respondent, the Panel has little alternative but to infer for present purposes that the Respondent's claims as to rights and legitimate interests in respect of the Domain Names are groundless.

This case demonstrates a panel can and will make findings of fact in the way that a court will make them. It also clearly shows a panel may draw inferences from the failure of a party to produce evidence.

### 1. Cases Where the Respondent has Succeeded in Proving a Right or Legitimate Interest in the Domain Name

The previous discussion concerned cases where respondents have failed to establish a right or legitimate interest in the domain name they registered. We will now consider cases where respondents have successfully established a right or interest in the contested domain name.

One such case is *Louis Vuitton Malletier SA v Manifest Information Services c/o Manifest Hostmaster*.<sup>239</sup> The high-end fashion luggage retailer Louis Vuitton Malletier filed a complaint against Manifest Information Services, the registered owner of the domain name <lv.com>. In its defence, the respondent showed the domain name resolved to a website which used to be a directory of Las Vegas businesses. The respondent thereby argued the prior use of the website provided a right or legitimate interest in the domain name. The panel agreed with the respondent, which ended a run of good luck by Louis Vuitton in domain name cases.<sup>240</sup>

Other respondents have also successfully proved rights or legitimate interests in domain names they used prior to the complaint. One such respondent proved he used 'Karajan' as a business and domain name years before the complaint was made.<sup>241</sup> Similarly, in the *Falwell Case* the respondent established he had used the domain name to run a website as a parody of Falwell.

Also recall the success of the respondent in the *Sam Francis Case*.<sup>242</sup> This was the case where there was the rather unusual dissent by one of the presiding panellists. The respondent had registered the domain name <samfrancis.com> and used it for the website of a commercial art gallery that sold only Sam Francis paintings. Equally importantly, the website did not claim that it was Sam Francis' own website. The panel found that the name 'has acquired distinctiveness and secondary meaning as a common law trademark and service mark when associated with works of art'.

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<sup>238</sup> *Glory Establishment v FutbolMasters Ltd, FW, FM, Steve Leighton*, WIPO Case No D2007-0439.

<sup>239</sup> NAF Case No FA0609000796276.

<sup>240</sup> *Louis Vuitton Malletier SA v Salvia Corporation*, NAF Case No FA0600968; *Louis Vuitton Malletier SA and Marc Jacobs Trademarks, LLC v Unasi Inc*, NAF Case No FA0603008; and *Louis Vuitton Malletier, SA v L Lui*, NAF Case No FA0630912.

<sup>241</sup> *Dr Werner Kupper [Executor of the Estate of the late Herbert von Karajan and Eliette von Karajan v Karajan Pty Ltd*, WIPO Case No D2000-1578.

<sup>242</sup> *Frederick M Nicholas, Administrator, The Sam Francis Estate v Magidson Fine Art, Inc*, WIPO Case No D2000-0673.

Then, the major issue the panel had to resolve was whether the respondent art gallery had a right or legitimate interest in the domain name. The respondent claimed that it did and relied on para 4(c) of the policy which meant that it had to show that it was ‘... making a legitimate non-commercial or fair use of the domain name, without intent for commercial gain to misleadingly divert consumers or to tarnish the trademark or service mark at issue’.

The panel majority decided the respondent had made fair use of the domain name. They explained that the website was clear that it was an art gallery which sold Sam Francis works. Therefore, there was clearly no misleading assertion that the artist had sponsored or authorised the website. They also noted the website did not tarnish the artist’s reputation since it offered to sell his paintings.

Interestingly, a similar scenario arose in *Thomas Blackshear v Christ-Centered Mall, Inc.*<sup>243</sup> but the respondent used the complainant’s name for a website which sold a number of artist’s works. The panel explained this was a significant difference because the respondent’s use of the complainant’s trademark promoted competing products. This was apparently not to the complainant’s benefit and possibly to his detriment. The panel thereby held the respondent’s actions were neither a ‘fair use’ of the contended domain name nor a ‘bona fide’ offer of goods. The result was the respondent had not made out a right or legitimate interest.

#### **m. How the Panel Goes About its Task**

How the panel defines ‘legitimate conduct’ influences whether the respondent will be found to have a right or legitimate interest in the domain name. Further, what constitutes legitimate conduct depends on the panel’s value judgments. Therefore, it is always difficult for courts or tribunals to define legitimate conduct. It is particularly difficult in UDRP proceedings where the case has to be decided on the papers, without the opportunity to hear witnesses. Some examples will further illustrate the difficulties panellists face to determine the legitimacy of the respondent’s conduct.

For example, consider the 2006 decision in the *New York Yankees Partnership d/b/a The New York Yankees Baseball Club v Covanta Corporation*.<sup>244</sup> The respondent used the domain name <nyyankees.com> for a website which provided links to third-party commercial websites. These linked websites offered tickets to the complainant’s professional sporting events and merchandise bearing the complainant’s NEW YORK YANKEES mark. They were a clearly commercial use of the domain name, but were they legitimate? The panel found the links were not a legitimate use of <nyyankees.com> on the basis of how paras 4(c)(i) and (iii) were interpreted in previous decisions.<sup>245</sup> They decided the links misled Internet users who sought tickets, merchandise, or information from the complainant’s registered website. Accordingly, the respondent had no rights or legitimate interest in the domain name, which also went to make out the third element of bad faith.

Another case where the respondent failed to establish a right or legitimate interest in the disputed domain name was *Lewis Black v Burke Advertising, LLC*.<sup>246</sup> The disputed domain

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<sup>243</sup> WIPO Case No D2002-0736.

<sup>244</sup> NAF Case No FA0803277.

<sup>245</sup> *TM Acquisition Corp v Sign Guards*, FA 132439 (Nat Arb Forum, 31 December 2002); *Bank of Am Corp v Nw Free Cmty Access*, FA 180704 (Nat Arb Forum, 30 September 2003).

<sup>246</sup> WIPO Case No D2006-1128.

name was <lewisblack.com> and referred to a ‘national[ly] known entertainer, actor and author’. The respondent claimed that:

The domain lewisblack.com was registered on 5 January of 2000 as a brand name for one of our client’s food products. Although the client has not yet launched the product we continued to register the domain each year and note on the website that it was the future home for the client’s cheese product. Investments have been made for over six years to utilize the name.

The panel issued an order which required the respondent to provide evidence of the anticipated launch of this cheese product. The respondent failed to provide such evidence so the panel decided there was no right or legitimate interest. The lack of evidence also led the panel to decide the domain name had been registered and used in bad faith. This again highlights the importance of evidence. In other cases, respondents have established a right or legitimate interest in the disputed domain name.<sup>247</sup> These respondents provided evidence of a *bona fide* offer of goods and services prior to notice of the dispute.

#### n. **Good Faith Use in this Context**

All may not be lost if a respondent fails to establish a right or legitimate interest in the domain name they registered. If the complainant fails to establish the domain name was registered in bad faith, the respondent will retain the rights to the domain name. The authority for this situation is *Nintendo of America Inc v Alex Jones*.<sup>248</sup> The case concerned computer games, so one could remark the respondent lost the battle but won the war.

In that case the 15-year-old respondent, a Mr Jones, registered the domain name <legendofzelda.com>, then set up a website devoted to the popular Nintendo game Legend of Zelda. The website carried a host of information about the game that must have been very compelling for its devotees. The panel rejected the claim that his fan site gave him a right or legitimate interest to the domain name. This was presumably because the fan site had links for commercial outlets. However, Mr Jones won in the end and still operates his fan site. He would not have his website if the complainant had proven the domain name was registered and used in bad faith.

#### o. **Conclusion**

It may seem an anodyne conclusion, but the success of each case will depend on its facts. It is clearly the duty on those presenting the case to ensure all possible evidence is put forward. The complainant trademark owner must provide evidence that the registrant of the domain name has no right or legitimate interest in the domain name. Conversely, the respondent must provide evidence that he or she has such a right or legitimate interest.

#### lxvi. **Rights and Legitimate Interests in Celebrity Fan Sites**

Respondents often argue they have rights or legitimate interests because they operate or operated a fan site. A proper, non-commercial fan site can certainly give rise to a right or legitimate interest.<sup>249</sup> Some commentators argue people are entitled to register domain names

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<sup>247</sup> *Jenna Massoli p/k/a Jenna Jameson, Jennasis Entertainment, Inc, Club Jenna, Inc v Linq Entertainment, Inc*, WIPO Case No D2004-1042.

<sup>248</sup> WIPO Case No D2000-0998.

<sup>249</sup> The WIPO Overview makes that point: *ibid* n 218.

in names of their heroes because it is an exercise of free speech. The free speech issue is certainly important in those cases where the domain name registrant says he or she was running a fan club site. It is the same argument used in the ‘sucks cases’, like <wallmartsucks.com> which have become popular in the United States.

To defeat the argument that the respondent registrant legitimately used the domain name to run a fan site, the complainant must provide evidence of commercial use. The fan site argument will be defeated if there is evidence that the respondent had used the site for commercial purposes;<sup>250</sup> for example, the disputed fan site has links to commercial sites or sells products. If the respondent has offered to sell the domain name for a profit that would also be evidence of commercial use. Such evidence would suggest the registrant sought to make money out of the celebrity’s name, rather than run a fan or criticism site.

#### p. Cases Where the Fan Site Argument was Successful

However, registrants of domain names can succeed, and some have, on the ground that their site is a genuine fan site. For example, a fan site for the band Pearl Jam was found to be a genuine fan site.<sup>251</sup> Similarly, a fan site for the Indian artist F N Souza was found to be genuine, despite a link to <www.amazon.com>.<sup>252</sup> Some genuine fan sites have similar links to enable devotees to find products, which is consistent with the expression of free speech.

Another successful fan site argument was made in the *Pat Benatar Case, White Castle Way, Inc v Jacobs*.<sup>253</sup> The panel explained that a number of factors indicated the fan site was a legitimate non-commercial use of the disputed domain name:

Respondent’s website provides a wide range of information concerning Pat Benatar, the recording artist. There are clear disclaimers on the website stating that it is not endorsed by or an official website of the recording artist. There is no evidence on the record of this proceeding that Respondent obtains any commercial benefit from the website. While he does make a recommendation regarding the Internet retailer which he believes to stock the widest selection of the recording artist’s work, there is no evidence that Respondent receives compensation from the retailer. Respondent is not seeking to disparage the recording artist. Complainant was aware of Respondent’s website and activities for a substantial period, and requested that his website be linked to its official website before changing its view and attempting to obtain a transfer of the disputed domain name.

A respondent unsuccessfully attempted in 2005 to prove they operated a legitimate fan site on the basis of the *Pat Benatar Case*.<sup>254</sup> The analogy was rejected and the whole fan site argument failed. The *Pat Benatar Case* was not followed because the complainant did not implicitly consent to the fan site and commercial dealing occurred through the website. Accordingly, no right or legitimate interest could be made out.

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<sup>250</sup> *JRR Tolkien Estate Limited v tolkien.net*, WIPO Case No D2003-0833.

<sup>251</sup> *Pearl Jam, A General Partnership v Streaming Digital Media Dot Com c/o Brian J Spencer*, NAF Case No FA023583.

<sup>252</sup> *Estate of Francis Newton Souza v ZWYX.org Ltd*, WIPO Case No D2007-0221.

<sup>253</sup> WIPO Case D2004-0001.

<sup>254</sup> *Société pour l’œuvre et la mémoire d’Antoine de Saint Exupéry — Succession Saint Exupéry-D’Agay v The Holding Company*, WIPO Case No D2005-0165.

A case that sits somewhat oddly with these fan site cases concerned a fan site for David Gilmour.<sup>255</sup> The panel decided the respondent was free to praise but this did not give a right or legitimate interest in the domain name. The case was probably influenced by the respondent's intention to use the domain name for commercial purposes.

#### q. Cases Where the Fan Site Argument was not Successful

There have also been many cases where the fan site argument has been unsuccessful. The majority of these cases failed because there was no fan club; only the plans for one existed. For example, in the *Jimi Hendrix Internet Fan Club Case*, the respondent claimed he had created a Jimi Hendrix Internet Fan Club.<sup>256</sup> He alleged he had detailed plans to provide services through the fan website. He pointed particularly to the email addresses he had issued. The panel decided his plans were not a use of a domain name for a fan club site. Also, the real reason he had registered the domain name was so he could issue the email addresses. Thus, the respondent was held to have no right or legitimate interest in the domain name.

Another early fan site case where the fan site argument was not successful was *Edward Van Halen v Deborah Morgan*.<sup>257</sup> There was no evidence the fan site had been operational long enough to have fans or devotees. Therefore, the panel held the respondent merely expected, but did not have, a legitimate interest in the domain name. Similarly, one panel indicated a respondent must establish the use of the website is 'substantial and genuine'.<sup>258</sup>

Many other respondents have failed to make the fan site argument because there was no evidence an actual fan site operated.<sup>259</sup> This includes a case where there was no evidence the respondent had prepared for the fan site of the domain name <ringostarr.mobi>.<sup>260</sup> In another Beatles' case, the panel found the respondent had not registered the domain names to create a George Harrison fan site.<sup>261</sup> Instead, he had attempted to use the domain name registration to coerce the complainant to sponsor a particular environmental movement. Clearly the respondent was not found to have a right or legitimate interest in the domain name. In another George Harrison case, the respondent similarly failed to establish a genuine fan site existed.<sup>262</sup>

In some cases the alleged fan site is operational but is simply not a fan site. For example, one website was merely a gateway where potential fans could apply for information about the Stevie Wonder fan club.<sup>263</sup> Whilst the site was clearly not commercial, the respondent failed to establish the site had an active fan base. Also, the website carried information about Stevie Wonder only after the domain name dispute was notified.

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<sup>255</sup> *David Gilmour, David Gilmour Music Limited and David Gilmour Music Overseas Limited v Ermanno Cenicolla*, WIPO Case No D2000-1459.

<sup>256</sup> *Experience Hendrix, LLC v Denny Hammerton and The Jimi Hendrix Fan Club*, WIPO Case No D2000-0364.

<sup>257</sup> WIPO Case No D2000-1313.

<sup>258</sup> *Julie Brown v Julie Brown Club*, WIPO Case No D2000-1628.

<sup>259</sup> *Robbie Williams v Howard Taylor*, WIPO Case No D2002-0588; *Joe Cole v Dave Skipper*, WIPO Case No D2003-0843; *Hugh Jackman v Peter Sun*, NAF Case No FA0403000248716; *Wayne Rooney's Case, Stoneygate 48 Limited and Wayne Mark Rooney v Huw Marshall*, WIPO Case No D2006-0916.

<sup>260</sup> *Richard Starkey v Mr Bradley*, NAF Case No FA0612000874575.

<sup>261</sup> *George Harrison v Lovearth.net*, NAF Case No FA097085 (2001).

<sup>262</sup> *George Harrison v IWebAddress.com*, NAF Case No FA0097090 (2001).

<sup>263</sup> *Stevland Morris a/k/a Stevie Wonder v Unofficial Fan Club c/o Web Master*, NAF Case No FA0453986.

Sometimes the case for a fan site is made out but does not establish a right or legitimate interest in the domain name. This was the case in *Anne of Green Gables Licensing Authority, Inc, v Internetworks*.<sup>264</sup> In that case it was held that the ‘respondent’s proposed use of the well-known mark owned by complainant to lure fans and potential tourists to Respondent’s web site is definitively not a legitimate use [emphasis added]’.

r. **Conclusion**

We have seen decisions where a right or legitimate interest has been made out by a successful argument that the respondent was using the domain name for a legitimate fan site.<sup>265</sup> We have also seen cases where that argument has failed.<sup>266</sup> Registrants of domain names are not always unlikely to establish that the domain name was used for a genuine fan site. Each case depends on its own facts and it is crucial for parties to provide evidence to prove their respective arguments. Cases can be, and still are, won on the facts.

**Ixvii. The Final Step: Bad Faith**

As we have seen, three elements must be proven before a complainant can succeed. As we have looked at the first two, it is time to look at the third element the celebrity must prove: the domain name has been registered and is being used in bad faith.

As in the case of rights or legitimate interests, the policy suggests how bad faith should be interpreted. Paragraph 4(b) of the policy sets out four circumstances, any one of which shall be evidence of the registration and use of a domain name in bad faith. Although the four circumstances are not exclusive; other circumstances may also be relied on. The specified circumstances are:

- (i) circumstances indicating that the respondent has registered or acquired the domain name primarily for the purpose of selling, renting, or otherwise transferring the domain name registration to the complainant who is the owner of the trademark or service mark or to a competitor of that complainant, for valuable consideration in excess of the respondent’s documented out-of-pocket costs directly related to the domain name; or
- (ii) the respondent has registered the domain name in order to prevent the owner of the trademark or service mark from reflecting the mark in a corresponding domain name, provided that respondent has engaged in a pattern of such conduct; or
- (iii) the respondent has registered the domain name primarily for the purpose of disrupting the business of a competitor; or
- (iv) by using the domain name, respondent has intentionally attempted to attract, for commercial gain, internet users to respondent’s website or other on-line location, by creating a likelihood of confusion with the complainant’s mark as to the source, sponsorship, affiliation, or endorsement of the respondent’s website or location or of a product or service on the site or location.

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<sup>264</sup> AF-00109 (eResolution Case, 2000).

<sup>265</sup> *Pearl Jam, Souza, Gary Jennings, Pat Benatar and Borges*.

<sup>266</sup> *Saint Exupery, David Gilmour, Hendrix, Van Halen, Julie Brown, Robbie Williams, Joe Cole, Hugh Jackman, Wayne Rooney, Ringo Starr, George Harrison and Kevin Spacey*.

The celebrity, like all other complainants in UDRP proceedings, has to show the domain name in question was registered and used in bad faith. Some celebrities have proven the respondent acted in bad faith and others have failed to do so. Those who establish the bad faith element are usually able to point to a number of indicative facts. For example, the domain name is linked to a commercial or pornography site or the respondent offered to sell the domain name to the complainant. Also, sometimes the respondent may not have a plausible explanation for why they registered the name or may appear untruthful.

*Madonna's Case* had quite a few elements which indicated the respondent's acted to trade off the complainant's name. The respondent did not explain why he registered <madonna.com>, used it for a sexually explicit website and valued the domain name at US\$20,000. The respondent merely stated 'Madonna' is an English word and did not attempt to relate the dictionary definition of Madonna to the website. Therefore, the only plausible explanation the panel could draw was the respondent had intentionally attempted to commercially gain from the complainant's name. The panel also noted a disclaimer on a website is not a defence to a bad faith claim. However, other cases indicate a disclaimer may defend a bad faith claim. This is especially when the disclaimer is prominently situated and clearly states the website is not associated with the trademark owner. Interestingly, the panel in *Madonna's Case* indicated the acquisition of a domain name in bad faith means the registration was in bad faith.

When the panel in *Madonna's Case* considered the bad faith element, it distinguished the *Sting Case* in an interesting way. Recall that in the *Sting Case* the alleged trademark was 'STING', both the name of a singer and a common English word. The panel found it plausible the respondent registered the domain name for some other reason than to trade off the fame of the celebrity concerned. The word 'sting' has obvious meanings other than the name of a singer. Compare this to the panel in *Madonna's Case* who found it difficult to think of a legitimate reason for choosing the name of the *über* celebrity Madonna.

#### s. **The Need for Evidence**

Whether bad faith is established depends on the particular facts of the case and the evidence provided to the panel. Many cases fail because the complainant has not appreciated the importance of adducing the necessary evidence or has simply not been able to present it. In UDRP cases it is particularly important to remember the element of bad faith requires something improper or immoral. For that reason complainants would be well advised to suggest or attempt to prove bad faith rather than assert it exists.

The importance of this improper or immoral requirement was noted in *Edward Van Halen v Deborah Morgan*,<sup>267</sup> where the complainant was unable to prove bad faith. The panel found the respondent had not attempted to sell the domain name or use it for a commercial purpose. They noted if the respondent had used the website to seek commercial gain the complainant's case would have been stronger. Also, the respondent had not engaged in 'abusive, bad faith cybersquatting' which the policy is designed to prevent. Compare this decision to the *Monty Roberts Case*<sup>268</sup> and *The Wiggles Touring Pty Ltd Case*<sup>269</sup> where both respondents were found to have used the respective domain names in bad faith.

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<sup>267</sup> WIPO Case No D2000-1313.

<sup>268</sup> 'Horse Whisperer' Case, *Monty and Pat Roberts, Inc v Bill Keith*, WIPO Case No D2000-0299.

#### t. Cases Where Bad Faith Has Been Established

Sometimes the respondent's bad faith is easy to prove. For example, many cases have established bad faith because the disputed domain name was linked to pornography.<sup>270</sup> In one case the sex therapist Dr Roger Libby established his domain name was linked to a hard-core pornography site.<sup>271</sup> The panel inferred the respondent either intended to sell the domain name or direct the complainant's clients to his pornography site. Therefore, the element of bad faith was easily established.

Recall that business people may find it difficult to show common law trademarks in their own name, rather than under a company or product. They also often find it hard to establish the respondent registered the disputed domain name in bad faith. However, such cases can succeed if inferences are drawn from the proper evidence produced. In one such case there was evidence the respondent linked the complainant's name in the disputed domain name to pornography.<sup>272</sup> In another, evidence suggested the respondent was in the business of domain name dealing.<sup>273</sup>

In many cases whether business people established bad faith depended on how the panel inferred the respondent's intentions from the evidence.<sup>274</sup> One such example was the finding of bad faith in the *Kendra Todd Case*.<sup>275</sup>

An experienced arbitrator can often quickly assess whether the conduct of the respondent indicates bad faith. In many cases bad faith has simply been inferred from the inability to find the respondent registered the domain name for a legitimate reason. In one case the respondent gave a very spurious explanation for registering the names of Venus and Serena Williams.<sup>276</sup> He claimed he intended to set up a sports site and sell the domain name for over US\$1 million. Therefore, it was easy to infer the registration and use of the domain name had been in bad faith. In another the respondent registered <fatactress.com> after the television show starring Kirstie Alley.<sup>277</sup> He directed the website to his own where he expressed his views on various issues such as pornography, abortion and Hollywood stars. The panel decided the only logical reason he would have done this was to use her fame for his ends.

Sometimes bad faith can be inferred from the mere fact the celebrity is well known. In such cases the respondent needs to rebut the inference the domain name was registered to trade on the name of the celebrity. For example, in a previously mentioned case bad faith was established because the respondent registered <ringostarr.mobi> and knew of Ringo Starr.<sup>278</sup>

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<sup>269</sup> *The Wiggles Touring Pty Ltd v Thompson Media Pty Ltd*, WIPO Case No D2000-0124.

<sup>270</sup> *A & F Trademark, Inc, Abercrombie & Fitch Stores, Inc, Abercrombie & Fitch Trading Co, Inc v Party Night, Inc*, WIPO Case No D2003-0172; *Barry Diller v INTERNETCO CORP*, WIPO Case No D2000-1734.

<sup>271</sup> *Dr Roger Libby v Tunga Tuzlaci and/or Tumay Asena*, WIPO Case No D2001-1342.

<sup>272</sup> *Barry Diller v INTERNETCO CORP*, WIPO Case No D2000-1734.

<sup>273</sup> *Philip Berber v Karl Flanagan and KP Enterprises*, WIPO Case No D2000-0661.

<sup>274</sup> *Joe Cole v Dave Skipper*, WIPO Case No D2003-0843; *David Gilmour, David Gilmour Music Limited and David Gilmour Music Overseas Limited v Ermanno Cenicola*, WIPO Case No D2000-1459.

<sup>275</sup> *Kendra Todd v Real Estate Radio c/o Leo Miller*, NAF Case No FA0783428.

<sup>276</sup> *Serena Williams and Venus Williams v Eileen White Byrne and Allgolfconsultancy*, WIPO Case No D2000-1673.

<sup>277</sup> *True Blue Productions, Inc v Chris Hoffman*, WIPO Case No D2004-0930.

<sup>278</sup> *Richard Starkey v Mr Bradley*, NAF Case No FA0612000874575.

**u. The Specific Criteria of Paragraph 4(b)**

Some cases are specifically decided on the basis of one or more of the criteria set out in para 4(b) of the policy.

**(i) Intention to Sell**

The relevant sub-paragraph in the policy is:

- (i) circumstances indicating that the respondent has registered or acquired the domain name primarily for the purpose of selling, renting, or otherwise transferring the domain name registration to the complainant who is the owner of the trademark or service mark or to a competitor of that complainant, for valuable consideration in excess of the respondent's documented out-of-pocket costs directly related to the domain name ...

Bad faith has been inferred from an intention to sell the domain name for some substantial benefit other than money. In one case the respondent's solicitors, somewhat unwisely, offered to sell the domain name for tickets, money or some other gesture.<sup>279</sup> This was held to infer bad faith.

A prominent case in this field to the same effect was *MPL Communications, Limited and MPL Communications, Inc v LOVEARTH.net*.<sup>280</sup> The case was decided on 1 June 2001 and concerned Paul McCartney. The respondent sought and gained an undertaking McCartney would read his environmental manifesto. The panel held this undertaking indicated bad faith under para 4(b)(i) of the policy. The panel also found there was bad faith under para 4(b)(i), (ii) and (iii) of the policy. This prominent case relied on a 2000 decision where another respondent similarly attempted to sell a domain name for a non-monetary benefit.<sup>281</sup>

As with many of the requisite elements of the UDRP domain name dispute process, it is important all relevant evidence is adduced. Where the complainant alleges the respondent offered the domain name for sale or was prepared to sell they should adduce the whole correspondence between the parties.<sup>282</sup>

**(ii) Denial of Corresponding Domain Name**

The relevant sub-provision of the policy is:

- (ii) the respondent has registered the domain name in order to prevent the owner of the trademark or service mark from reflecting the mark in a corresponding domain name, provided that respondent has engaged in a pattern of such conduct.

One case where the decision turned on this element was *Stevland Morris a/k/a Stevie Wonder v Unofficial Fan Club c/o Web Master*.<sup>283</sup> This case was previously discussed in terms of 'rights or legitimate interests' and common law trademarks. It is worth a further mention as

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<sup>279</sup> *Mr Severiano Ballesteros Sota, Fairway, SA and Amen Corner, SA v Patrick Waldron*, WIPO Case No D2001-0351.

<sup>280</sup> NAF Case No FA0097086.

<sup>281</sup> *Metallica v Josh Schneide*, NAF Case No FA0095636.

<sup>282</sup> *Die Marlene Dietrich Collection GmbH v Johan Duplesis Du Plesis*, WIPO Case No D2007-1306.

<sup>283</sup> NAF Case No FA0453986 (2005).

the panel held there had been bad faith on the basis of an interesting proposition. The panel stated:

In the present case, the Panel finds that this allegation (a breach of sub paragraph (ii)) is proved conclusively. It is true that complainant has established a very full site to promote his activities at <www.steviwonder.net> but *everyone knows that a '.com' site is to be preferred* and it is where an Internet user looking for information about the singer would look first, so Respondent's registration of <steviwonder.com> has been a barrier to Complainant [emphasis added].

This proposition is debatable, although the other panellists in the case supported it.

### ***(iii) Disrupting the Business of a Competitor***

The relevant sub-provision of the policy is:

- (iii) the respondent has registered the domain name primarily for the purpose of disrupting the business of a competitor.

An intention to disrupt the business of a competitor has been interpreted broadly. It may include the intention to mislead consumers or divert internet traffic away from the competitor complainant. In all cases the complainant must show only one inference can be drawn from the respondent's conduct. Of course, this inference must be that it was an intention to disrupt his or her business. Such cases can succeed but they can also fail. For an unsuccessful case see *Frederick M Nicholas, Administrator, The Sam Francis Estate v Magidson Fine Art, Inc.*<sup>284</sup>

### ***(iv) Creating Confusion***

The relevant provision of the policy is:

- (iv) by using the domain name, respondent has intentionally attempted to attract, for commercial gain, internet users to respondent's website or other on-line location, by creating a likelihood of confusion with the complainant's mark as to the source, sponsorship, affiliation, or endorsement of the respondent's website or location or of a product or service on the site or location.

Many cases on this sub-provision, revolve around whether the respondent attempted to create a false impression of the complainant's endorsement of a product. There are many examples where the intention and result was people were misled to believe the complainant endorsed the respondent's goods and services. However, there are also cases where the panel has concluded the respondent did not intend to create any confusion.

There are many cases where the panel has inferred the respondent intended to create confusion with the complainant's mark and thereby acted in bad faith. Examples include the *Dan Marino Case (supra)*, the *Anne of Green Gable Case*<sup>285</sup> and the *Gene Kelly Case*.<sup>286</sup> In

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<sup>284</sup> WIPO Case No D2000-0673.

<sup>285</sup> *Anne of Green Gable Licensing Auth, Inc v Internetworks*, AF-0109 (eResolution Case, 12 June 2000).

<sup>286</sup> *Gene Kelly Image Trust v BWI Domain Manager*, WIPO Case No D2008-0342.

the last case the domain name referred to Gene Kelly and led to a website with sponsored links. The majority of these links ‘relate[d] to movies or Gene Kelly’ which was held to constitute bad faith registration and use. Also, interestingly, bad faith was established on the basis of para 4(b)(iv) in a case which involved the domain name <www.thesimpsonsmovie.com>.<sup>287</sup>

What is the test to be applied? One answer was given in *Société pour l’œuvre et la mémoire d’Antoine de Saint Exupéry — Succession Saint Exupéry — D’Agay v The Holding Company*.<sup>288</sup> The panel explained the applicable test in the following way:

The question that remains is whether an average Internet user is likely to get the impression of sponsorship or affiliation in the presence of a disclaimer (which may have been added only after the complainant notified the respondent).

This test was apparently applied in a case which involved the sports person Michael James Owen.<sup>289</sup> The panel found when the respondent registered the domain name at issue, he should have known of Michael Owen. Further, the respondent must have been aware the registration of the disputed domain names would infringe on the complainant’s rights. It is interesting that the panel made no explicit reference to the impression of an average Internet user.

#### v. Other Successes on Bad Faith

In the *Jimi Hendrix Fan Club Case (supra)*, Hendrix’s estate won on bad faith as on the other issues.<sup>290</sup> The bad faith claim succeeded because the respondent was a known serial celebrity cybersquatter and offered to sell the disputed domain name. However, a respondent may also be found to have acted in bad faith even if it was an obvious one-off transgression. For example, in the *Richard Juzwin Case* the panel inferred bad faith because the registration of the domain name included the celebrity’s full name.<sup>291</sup>

Clearly inferences can be drawn against the respondent when his or her conduct is consistent with allegations of bad faith. This was further illustrated in the case of Wayne Rooney, the Everton and then Manchester United footballer.<sup>292</sup> In this case the trademark was registered after the domain name. The panel found when the respondent registered the domain name he knew the second complainant would become ‘very hot property’. Also, he registered the domain name with a view to create a site from which to derive commercial benefits. The panel therefore concluded, in these circumstances, the domain name was registered and used in bad faith.

Not only was bad faith proved in *Tolkien’s Case (supra)* but bad faith has been established in a sense broader than those described in para 4(b) of the policy. The panel found the respondent registered a domain name which referred to Marlene Dietrich to exploit the trademark holder’s reputation.<sup>293</sup> The panel said when a domain name is registered in the

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<sup>287</sup> *Twentieth Century Fox Film Corp v KeithMalley.com*, WIPO Case No D2007-0760.

<sup>288</sup> WIPO Case No D2005-0165.

<sup>289</sup> *Michael James Owen v MSM Commercial Services*, WIPO Case No D2006-0155.

<sup>290</sup> *Experience Hendrix, LLC v Denny Hammerton and The Jimi Hendrix Fan Club*, WIPO Case No D2000-0364.

<sup>291</sup> *Richard Juzwin v Glen Stephens Stamps*, NAF Case No FA00097690 (2001).

<sup>292</sup> *Stoneygate 48 Limited and Wayne Mark Rooney v Huw Marshall*, WIPO Case No D2006-0916.

<sup>293</sup> *Die Marlene Dietrich Collection GmbH v Johan Duplesis Du Plesis*, WIPO Case No D2007-1306.

name of such a famous person they could conclude that ‘the Respondent registered the Domain Name with the intention of exploiting, in one shape or form, the goodwill associated with the complainant’s widely known trademark ...’.

#### w. Cases Where Bad Faith Has Not Been Proven

Not all celebrities have proven the respondent acted in bad faith. For example, in *White Castle Way, Inc v Jacobs*,<sup>294</sup> (the *Pat Benatar Case*) the panel said:

Respondent’s website provides a wide range of information concerning Pat Benatar, the recording artist. There are clear disclaimers on the website stating that it is not endorsed by or an official website of the recording artist. There is no evidence on the record of this proceeding that Respondent obtains any commercial benefit from the website. While he does make a recommendation regarding the Internet retailer which he believes to stock the widest selection of the recording artist’s work, there is no evidence that Respondent receives compensation from the retailer. Respondent is not seeking to disparage the recording artist. Complainant was aware of Respondent’s website and activities for a substantial period, and requested that his website be linked to its official website before changing its view and attempting to obtain a transfer of the disputed domain name. The combination of these factors leads the panel to conclude that Respondent is engaging in legitimate non-commercial use of the disputed domain name.

That extract contains a host of indicia which, when taken together, justify a finding that the respondent was not acting with an immoral or malevolent intention. A similar effect was reached by the majority decision in the *Sam Francis Case*.<sup>295</sup> The complainant failed to prove bad faith on the facts and thereby lost its claim to the domain name.

The *Sam Francis Case* was followed in *Thomas Blackshear v Christ-Centered Mall, Inc (Thomas Blackshear Case)*.<sup>296</sup> The panel in that case found the disputed domain name had been registered and used in bad faith because:

In evaluating the facts in this case, where Respondent does offer the works of other artists at its site, the Panel concludes that Respondent, fully aware of the notoriety of Complainant’s name, has intentionally attracted consumers to Respondent’s web site for the purchase of those works (as distinct from Complainant’s works, which Respondent also hopes to sell) by creating the false impression that they are sponsored or endorsed by Complainant.

Some observers may argue the dissenting view in the *Sam Francis Case* is the more generally accepted approach in UDRP cases. For example, the panel in *Estate of Shakur v Shakur Info Page*,<sup>297</sup> found bad faith in registering a domain name in the artist’s name and not much else. The respondent’s email address was on a site which sold bootlegged Shakur CDs which apparently was sufficient to establish bad faith.

In other cases when there is persuasive evidence, bad faith tends to be established on the balance of probabilities. Celebrities such as Nicole Kidman<sup>298</sup> and Nick Cannon<sup>299</sup> have been

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<sup>294</sup> WIPO Case No D2004-0001 (2004).

<sup>295</sup> *Frederick M Nicholas, Administrator, The Sam Francis Estate v Magidson Fine Art, Inc*, WIPO Case No D2000-0673.

<sup>296</sup> WIPO Case No D2002-0736.

<sup>297</sup> AF-0346 (eResolution Case, 28 Sept 2000).

<sup>298</sup> *Nicole Kidman v John Zuccarini, d/b/a Cupcake Party*, WIPO Case No D2000-1415.

able to raise sufficient evidence to establish bad faith. Registration and use of a domain name in bad faith was also proven by the Slovenian lady motorbike rider in *Bernardka Pulko v Greg Frazier*.<sup>300</sup> The panel said:

The domain name <benkapulko.com> is used for commercial gain, namely to sell different products or advertisements connected with motorcycling. This reflects Respondent's attempt to attract users to its website by improperly associating itself with Complainant's mark and name and misleadingly suggesting an affiliation with, or sponsorship by, Complainant.

Sometimes the panel will make a finding of no bad faith because there are too many discrepancies in the evidence. For example, in *Bob Avila v B&B Productions*,<sup>301</sup> the respondent alleged he shared the domain name and website with the complainant in a partnership. The complainant denied this and claimed full rights to the domain name and website. There were simply too many conflicts in the evidence for the panel to decide the issue of bad faith.

The panel might also make a finding of no bad faith because the complainant failed to prove his or her assertions. This was so in the case of the Czech pornography star Sylvie Saint in *Silvie Tomalová aka Sylvia Saint v Juan Campos*.<sup>302</sup> In other cases the fact the evidence is unsatisfactory leads the panel to conclude there probably *was* bad faith. That was so in *Glory Establishment v FutbolMasters Ltd, FW, FM, Steve Leighton*.<sup>303</sup> In other words, the panel will draw inferences from the respondent's acts and omissions throughout the proceedings. This again shows it is important parties present the best case possible by way of evidence and submissions.

A further good illustration of how a panel will work its way to a finding of no bad faith use and registration is *Borges, SA, Tanio, SAU v James English*.<sup>304</sup> The complainant was a manufacturer and had a trademark on the name BORGES. However, when the respondent registered the disputed domain name he thought of the famous writer of the same name and did not know of the complainant. The panel accepted this explanation which foundered the finding of no bad faith. No other ground could be found against the respondent to negate right or legitimate interest or show bad faith, so the complainant lost.

An earlier case where the complainant failed to prove bad faith was the *Dr Albert Einstein Case*.<sup>305</sup> On the issue of bad faith, the panel said:

... there is no evidence Respondent had Complainant in mind when registering the disputed domain name and ... it was unaware Complainant claimed trademark rights in the name ALBERT EINSTEIN.

Sometimes the evidence is just not there, as in *Pearl Jam, A General Partnership v Streaming Digital Media Dot Com c/o Brian J Spencer*.<sup>306</sup> On bad faith the panel said: 'There is no evidence that any of the circumstances in paragraph 4(b) of the Policy apply to Respondent

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<sup>299</sup> *Nick Cannon v Modern Limited-Cayman Web Development*, WIPO Case No D2005-0757.

<sup>300</sup> WIPO Case No D2006-0099.

<sup>301</sup> WIPO Case No D2004-0013.

<sup>302</sup> WIPO Case No D2006-0379.

<sup>303</sup> WIPO Case No D2007-0439.

<sup>304</sup> WIPO Case No D2007-0477.

<sup>305</sup> *The Hebrew University of Jerusalem v Alberta Hot Rods*, WIPO Case No D2002-0616.

<sup>306</sup> NAF Case No FA0235831.

and hence no evidence of bad faith'. Pearl Jam had more success in obtaining domain names in other cases.<sup>307</sup>

**x. Bad Faith by Inaction**

It is not always necessary to prove the respondent acted in bad faith by positive acts. Some celebrity cases have established the requirement of bad faith by inaction under the principle espoused in *Telstra v Nuclear Marshmallows*. Thus, it was said in *Michael J Feinstein v PAWS Video Productions*,<sup>308</sup> that:

... the Respondent posted no content on the corresponding website prior to receiving notice of this dispute and that such failure to post content constitutes 'inaction' under Telstra. This inaction considered together with the refusal of Respondent to communicate with Complainant and with the creation of a firewall to block Complainant's monitoring of content constitute a separate basis for finding bad faith.

The same view was expressed in *Société pour l'Oeuvre et la Mémoire d'Antoine de Saint Exupéry — Succession Saint Exupéry — D'Agay v Perlegos Properties*.<sup>309</sup>

**y. Improper Use of a Fan Site May Amount to Bad Faith**

We have already looked at *Kevin Spacey v Alberta Hot Rods*<sup>310</sup> under other elements. However, this is a case where the case was made complete with an adverse finding on bad faith. The panel said:

Complainant argues that both of Respondent's uses of the <kevinspacey.com> domain name — first diverting Internet traffic to <celebrity1000.com> and then connecting the domain name to an unauthorized fan website — constitute an opportunistic attempt to trade off Complainant's fame. Complainant contends that Respondent's initial use of the domain name, before notification of Complainant's objections, is bad faith under Policy ¶ 4(b)(iv) because Internet users were misleadingly diverted to the <celebrity1000.com> domain name that had banner advertisements from which Respondent profited. We agree.

In the other *Spacey Case*, *Kevin Spacey v John Zuccarini*,<sup>311</sup> the domain name at issue was <kevinspacey.com> so there was a spelling difference. Bad faith was again established because the '[r]espondent is a well known cybersquatter and has "admitted that he registered ... thousands of other domain names because they are confusingly similar to others' famous marks and personal names ... in an effort to divert Internet traffic to his sites ...".

Also, the respondent did not use the website for legitimate purposes but to carry pop-up ads for which he was paid. These facts made it clear there had been bad faith in the registration and use of the domain name.

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<sup>307</sup> *Pearl Jam, A General Partnership v Phoebe's Fantasy Playhouse and n/a c/o John Hewell*, NAF Case No 226451; *Pearl Jam, A General Partnership v Adot LP c/o Robert Dunlap*, NAF Case No 232955; *Pearl Jam, A General Partnership v Francesco Catalano*, NAF Case No 236583; and *Pearl Jam, A General Partnership v Vertical Axis, Inc c/o Domain Administrator*, NAF Case No 593325 .

<sup>308</sup> WIPO Case No D2000-0880.

<sup>309</sup> WIPO Case No D2005-1085.

<sup>310</sup> NAF Case No FA0114437.

<sup>311</sup> NAF Case No FA0096937.

Similarly, in *George Harrison v LOVEARTH.net*<sup>312</sup> it was held the domain names had been registered and used in bad faith. However, there had also been a desultory argument that the domain name was being used for a fan site.

#### **z. Falling at the Last Hurdle**

Sometimes celebrities prove the first two elements but ultimately fail because of an inability to prove bad faith. This was the case in *Edward Van Halen v Deborah Morgan*,<sup>313</sup> which concerned the co-founder of the hard rock band, Van Halen.

Bad faith was also not made out in *Estate of Gary Jennings v Submachine*.<sup>314</sup> On that issue the panel commented that although the respondent also had other celebrity domain names, '[t]he Panel is not persuaded that Respondent has engaged in a pattern of registering domain names in order to prevent the owner of the trademark or service mark from reflecting the mark in a corresponding domain name'. Moreover, the respondent had made no effort to sell the domain name, it did not appear that the respondent sought to disrupt the complainants' business, and although the domain name was linked to a commercial outlet, 'based on the evidence presented, Respondent has not sought commercial gain'.

Another complainant failed on the grounds of bad faith despite success on the previous two issues in *Mark Warner 2001 v Mike Larson*.<sup>315</sup> The element of bad faith was not established because use of the candidate's name or campaign as a domain name would attract internet uses for political gain, not commercial benefit.

Another complainant succeeded on the first two elements but failed to establish bad faith and hence lost the entire proceedings in *Nintendo of America Inc v Alex Jones*.<sup>316</sup> This decision is particularly interesting as there was a robust finding that the respondent who had registered the domain name had no right or legitimate interest in doing so. He also had no valid claim that he operated a fan site. Yet this was not followed by a finding he had registered or used the domain name in bad faith. For the young respondent, this was a very narrow escape.

The respondent had registered <legendofzelda.com> as a fan site for fans of the popular Nintendo game. He agreed that the domain name was identical to the trademark, but he claimed he had a right or legitimate interest in the domain name and he denied that he had registered or used it in bad faith. The panel rejected his claim that he had a right or legitimate interest in the domain name for reasons that we have already seen. However, when it came to the issue of bad faith, he was successful; the panel found that he had not been guilty of bad faith as the evidence showing bad faith was simply not there. The panel said:

The Respondent has made no effort to sell the subject domain name ... there is no evidence that the Respondent has engaged in a pattern of such conduct as required by the Policy.

The evidence does not support a finding that the Respondent seeks to disrupt the business of the Complainant. In fact, the opposite appears to be true.

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<sup>312</sup> NAF Case No FA0097085.

<sup>313</sup> WIPO Case No D2000-1313.

<sup>314</sup> WIPO Case No D2001-1042.

<sup>315</sup> NAF Case No FA0095746.

<sup>316</sup> WIPO Case No D2000-0998.

The evidence is clear that the respondent has not sought commercial gain. Although his website contains links to commercial outlets, he states that he derives no personal gain.

The circumstances in the Policy from which evidence of bad faith can be inferred are not present. Taking the evidence as a whole, there is no other basis on which the Administrative Panel could find bad faith.

On this basis the respondent still won despite the complainant's establishment of the first two elements. It is worth looking at the website, which is still in operation: <www.legendofzelda.com>. On the facts of the case and after a look at the website it is difficult to see what harm the fan site could cause the complainant. The band of young devotees on the website seems to have nothing at heart but the welfare and advancement of the complainant and its computer game.

#### v Conclusion on this Issue

The above discussion indicates parties have almost equal chances of success or failure on the bad faith element. This reflects an impartial system where success depends on the particular facts and evidence adduced in each case.

### 36. 6. Celebrities as Respondents and Other Oddities

Of course celebrities can sometimes be respondents, not complainants. But the only case I know of was unsuccessful. It is *Morgan Stanley v Meow*.<sup>317</sup> In that case the full name of the respondent was Meow, Baroness Penelope Cat of Nash DCB. The domain name at issue was <mymorganstanleyplatinum.com>. It is an amusing decision and one which is authority for the proposition that a domain name may not be registered in the name of a cat.

Another odd situation is where the domain name is or is said to be the celebrity, but the celebrity is not the complainant, the respondent has clearly never heard of the complainant and the complainant has probably never heard of the celebrity. That was the case in *Borges, SA, Tanio, SAU v James English*,<sup>318</sup> to which reference has already been made. The disputed domain name was <borges.com>, registered to invoke the name of the author, but the claim was brought by the Borges company. The respondent claimed to be a fan of the writer Borges. The domain name was directed to a site presumably maintained by the registrant with links, some of which were to sites dealing with the writer. It was held that the registrant had a right or legitimate interest in the domain name, as the site was used only as a critical literary site and could not have been in competition with the complainant's products.

### 37. 7. Conclusion

Perhaps a fitting conclusion about celebrities and their domain names might be said to be the remarks of a very experienced panellist, Mr Peter Michaelson, in *MPL Communications, Limited and MPL Communications, Inc v LOVEARTH.net*.<sup>319</sup>

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<sup>317</sup> NAF Case No FA0604000671304.

<sup>318</sup> WIPO Case No D2007-0477.

<sup>319</sup> NAF Case No FA0097086.

A celebrity, having rights resulting through registration and/or common law, is entitled to the exclusive control and exploitation of his (her) mark in connection with the goods and services with which that celebrity is associated and provides (either directly or, e.g., via license) under that mark.

# LEGISLATING EVIL: THE PHILOSOPHICAL FOUNDATIONS OF THE NAZI LEGAL SYSTEM

Augusto Zimmermann\*

## Abstract

This article is focused on the philosophical foundations of Nazi legal order and theory. The Nazis developed a theory of law in which ‘law’ was interpreted as a result of force and social struggle. Because the Nazis believed the ‘stronger’ have the ‘right’ to dispossess and destroy the ‘weaker’, a ‘master morality’ was developed, and it became meaningless to appeal to any higher law above the oppressive commands of the Nazi state. The ideology of National Socialism was forged primarily through the combination of a glorification of the all-powerful state through a nationalistic type of popular socialism, with a pseudo-scientific form of social Darwinism. The article examines each of these foundations, as well as the decisive role of the German juridical elite in the decline of justice and legality during the Third Reich. The correlation between the Nazi legal system and the complete disregard for the rights of the individual manifested itself most glaringly in the contribution of legal academics, judges and lawyers. During that time, most German judges and lawyers were authoritarians who rejected the concept of basic human rights as defined by classical natural law theory. This article demonstrates that judges, lawyers and legal academics were all disproportionately supportive of the Nazi cause.

## 38. Introduction

This article focuses on the philosophical foundations of the Nazi legal system and it also explains why the Nazi legal system cannot be isolated from the philosophical viewpoints of Nazi Germany’s juridical elite. During the period in question, most German judges, lawyers and legal academics opposed democratic constitutionalism and supported an authoritarian legal system that rejected any idea of a higher law or principle overseeing the state. Their practical and theoretical involvement in the Nazi regime is therefore analysed, and the degree to which they can be found innocent or guilty of complicity in the Nazi atrocities is also considered.

## 39. Nazism and Socialism

In his 1939 work *Germany Rampant*, the long-serving British diplomat Ernest Hambloch listed the Nazis and the communists as the two most revolutionary groups during the Weimar Republic. Curiously, the Nazi Party was not described by Hambloch as a ‘reactionary’, but rather as a ‘revolutionary party’, as much as the Communist Party.<sup>1</sup> Indeed, as Karl Dietrich Bracher explains:

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\* LLB, LLM (cum laude), PhD (Mon). Lecturer in Law, Murdoch University, School of Law, Western Australia. The author wishes to thank A/Professor Thomas Crofts, Frank Gashumba and Nicholas Summers for reading and commenting on this article.

<sup>1</sup> E Hambloch, *German Rampant: A Study in Economic Materialism* (1939) 135.

To see Fascism and National Socialism only as the final stage of a reactionary counterrevolution and to deny their revolutionary content is a fallacious oversimplification of these complicated relationships. The well-springs of the Fascist and National Socialist ideologies were nourished by ... national imperialism as well as statism, popular socialism as well as racism.<sup>2</sup>

The eradication of constitutional government and free-market capitalism were two of the most important goals of the National Socialist movement. As revolutionary socialists, the Nazis despised the bourgeoisie, traditionalists, aristocrats, monarchists, and all believers in the rights of the individual.<sup>3</sup> Similar to their communist counterparts, they pursued a form of anti-capitalist, anti-liberal, and anti-conservative socialism, which in their case was encapsulated in the concept of *Volksgemeinschaft*, or ‘people’s community’.<sup>4</sup> This is actually the reason that communists and Nazis often voted together in the Reichstag during the Weimar Republic.<sup>5</sup>

The first and only platform of the Nazi Party was overtly socialistic. It called for the confiscation of all income unearned by work as well as the acquisition of a controlling interest by the people in large corporations. Co-written in 1920 by Hitler and Anton Drexler, and issued by the Nazis as their ‘unalterable’ and ‘eternal’ objectives, that platform, apart from its notorious appeals to xenophobic nationalism and denunciation of the Treaty of Versailles, supported guaranteed employment, the expropriation of land without compensation, the nationalisation of industry, and the abolition of market-based lending.<sup>6</sup>

The Nazis believed their totalitarian state had the moral obligation to intervene in every aspect of the economy. They wished to keep it in line with their ideals of ‘social justice’ and the ‘national interest’. For such purpose they introduced a form of graduated Bolshevism which focused first upon Jewish bankers, industrialists and businessmen, but then later upon any other businessperson. As a result, some businesses were expropriated, whereas others were gradually subjected to intense overregulation, with their profits strictly controlled.

From the 1930s, state ownership increased dramatically in both war and non-war sectors of the German economy.<sup>7</sup> The Nazi-created economic policies dramatically expanded the state’s control over prices, labour, materials, dividends and foreign trade. These policies also restricted competition and private ownership in an attempt to direct all segments of the economy towards a policy of ‘general welfare’.<sup>8</sup> Indeed, the intellectual frontrunners of National Socialism strongly believed that capitalism had to be eliminated, because it supposedly favoured only the ‘unproductive’ industrialists and speculators, instead of the ‘honest workingman’. Economic liberalism was accused by them of lowering the birth rate of the working people, whom they regarded as constituting ‘the best of the nation’.<sup>9</sup>

The Nazi leader Adolf Hitler had, in his youth, very closely studied how the Marxist-oriented Social Democrats had so successfully manipulated the crowds in his native Austria. From that empirical observation, he further developed his own method of crowd psychology, which he

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<sup>2</sup> K D Bracher, *The German Dictatorship: The Origins, Structure and Effects of National Socialism* (1970) 10.

<sup>3</sup> J Goldberg, *Liberal Fascism* (2007) 59.

<sup>4</sup> *Ibid* at 69.

<sup>5</sup> *Ibid* at 77.

<sup>6</sup> The full platform of the Nazi Party can be found in Goldberg (2009) 410–13.

<sup>7</sup> P Panayi, *Weimar and Nazi Germany* (2000) 50.

<sup>8</sup> W J Rinderle and B Norling, *The Nazi Impact on a German Village* (1993) 148.

<sup>9</sup> *Ibid* at 14.

undoubtedly used to a rather astonishing success. In both public and private conversations, Hitler was quite willing to concede his debt to Marxism. In a party ceremony in November 1941, the *Führer* went even to the point of publicly declaring that, in his opinion, ‘basically, National-Socialism and Marxism are the same’.<sup>10</sup> As Hitler once commented:

I have learned a great deal from Marxism as I do not hesitate to admit. I don’t mean their tiresome social doctrine or the materialist conception of history ... But I have learned from their methods. The difference between them and myself is that I have really put into practice what these peddlers and pen-pushers have timidly begun. The whole of National Socialism is based on it. Look at the workers’ sports clubs, the industrial cells, the mass demonstrations, the propaganda leaflets written specially for the comprehension of the masses: all these new methods of political struggle are essentially Marxist in origin. All I had to do is take over these methods and adapt them to our purpose. I only had to develop logically what Social Democracy repeatedly failed in because of its attempt to realize its evolution within the framework of democracy. National Socialism is what Marxism might have been if it could have broken its absurd and artificial ties with a democratic order.<sup>11</sup>

There were several things in common between Hitler and Karl Marx. For instance, although Marx himself was a Jew he used in his letters to rail against ‘dirty Jews’ and denounce his political enemies with phrases like ‘nigger-like Jew’.<sup>12</sup> Furthermore, what Hitler most hated about Marxism had absolutely nothing to do with its economic doctrine, but rather its idea that the ‘workingmen have no country’. This was Marx’s most unacceptable postulation to Hitler. In the area of economics, however, the Marxian concept of ‘proletarian dictatorship’ was deeply inspirational for most Nazi leaders. In 1925, for instance, the notorious Nazi Propaganda Minister Joseph Goebbels stated in the Nazi daily *Völkischer Beobachter* in 1925 that, in his opinion, only a ‘socialist dictatorship’ could save the German nation from social chaos.<sup>13</sup> And of his own National Socialist Party, Goebbels described it as a party of ‘revolutionary socialists’.<sup>14</sup> The only major difference between the Nazis and the communists, he explained, was the internationalism of the latter.<sup>15</sup>

Of course, the Nazi Party was not international-socialist but rather national-socialist. So the great divide between the Nazis and the communists was not so much over economics, even though there were doctrinal differences between them, but primarily over the question of nationalism. And yet, there was a deep convergence of ideas between Marxism and National Socialism. Such convergence was made clear even before Hitler and Stalin turned into allies during the first years of World War II. While it is true that Hitler condemned the particular incarnation of Marxism in Soviet Russia, he was quite happy to regard his political movement as fully socialist in nature. Consider then the following words expressed by Hitler at a rally of the Nazi Party on 1 May 1927:

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<sup>10</sup> A Hitler, Public Speech, Munich, November 1941. Cited in *The Bulletin of International News*, Royal Institute of International Affairs, XVIII, No 5, 269.

<sup>11</sup> H Raushning, *Hitler Speaks* (1939), 134.

<sup>12</sup> In a letter to Engels Marx wrote this about the German socialist leader Ferdinand Lassalle: ‘It is not perfectly clear to me that, as the shape of his head and the growth of his hair indicates, he is descended from the Negroes who joined in Moses’ flight from Egypt (unless his mother or grandmother on the father’s side was crossed with a nigger). This union of Jew and German on a Negro base was bound to produce an extraordinary hybrid’: cited in P Johnson, *The Intellectuals* (1988) 62.

<sup>13</sup> R Pipes, *Russia Under the Bolshevik Regime 1919–1924* (1997) 260.

<sup>14</sup> M H Kele, *Nazi and Workers* (1972) 93.

<sup>15</sup> *Ibid* at 92.

We are socialists. We are enemies of today's capitalistic system for the exploitation of the economically weak, with its unfair salaries, with its unseemly evaluation of a human being according to wealth and property instead of responsibility and performance, and we are determined to destroy this system under all conditions.<sup>16</sup>

The false notion that communism and Nazism are polar opposites on the political spectrum serves to hide the truth that they are in fact 'kindred spirits'. According to Jonah Goldberg, 'the most striking thing about the platform of the Nazi Party was its concerted appeal to socialistic and populist economics, including providing a livelihood for citizens; abolition of income from interest; the total confiscation of war profits; the nationalisation of trusts; shared profits with labour; expanded old-age pensions; "communisation of department stores"; the execution of "usurers" regardless of race; and the outlawing of child labour'.<sup>17</sup> Hence, the only reason the Nazis aimed firstly to eliminate 'the Left', before they went after the traditionalist 'Right', might be related to the fact that Nazism actually attracted the same kinds of people. As Goldberg explains,

The Nazis may not have called themselves left-wingers, but that's almost irrelevant. For one thing, the left today — and yesterday — constantly ridicules ideological labels, insisting that words like 'liberal' and 'left' don't really mean anything ... For another, the 'social space' the Nazis were fighting to control *was on the left*. Not only the conventional analysis ... but most Marxist analysis concedes that the Nazis aimed first to 'destroy the left' before they went after the traditionalist right. The reason for this was that the Nazis could more easily defeat opponents on the left because they appealed to the same social base, used the same language, and thought in the same categories.<sup>18</sup>

The putative association of the Nazis with industrialists is therefore a fallacy created for convenience by the Soviet Government and its fellow travellers in the West. The canard that industrialists had always supported Hitler is one of the most notorious examples of ideological distortion of historical facts. In reality, the Nazis received very little support from the industrialists who later benefited from rearmament.<sup>19</sup> The Krupp family, for example, had financially opposed Hitler in the 1932 presidential election. From its earliest days in power the Nazi Party not only reduced the power of employers but also overtaxed the 'rich' and championed the 'right' of the state to protect the working class from any real or perceived 'excesses' of those 'capitalists'. As Richard Pipes points out:

The Nazis appealed to the socialist traditions of German labor, declaring the worker 'a pillar of the community', and the 'bourgeois' — along with the traditional aristocracy — a doomed class. Hitler, who told associates that he was a 'socialist', had the party adopt the red flag and,

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<sup>16</sup> A Hitler, Public Speech, Munich, May 1 1927: cited in J Toland, *Adolf Hitler* (1976) 306.

<sup>17</sup> Goldberg (2007) 69.

<sup>18</sup> *Ibid* at 70.

<sup>19</sup> Goldberg comments: 'In Germany the aristocracy and business elite were generally repulsed by Hitler and the Nazis. But when Hitler demonstrated that he wasn't going away, these same elites decided it would be wise to put down some insurance money on the upstarts. This may be reprehensible, but these decisions weren't driven by anything like an ideological alliance between capitalism and Nazism. Corporations in Germany, like their counterparts today, tended to be opportunistic, not ideological ... The Nazis rose to power exploiting anti-capitalist rhetoric they indisputably believed. Even if Hitler was the nihilist cipher many portray him as, it is impossible to deny the sincerity of the Nazi rank and file who saw themselves as mounting a revolutionary assault on the forces of capitalism. Moreover, Nazism also emphasized many of the themes of later New Lefts in other places and times: the primacy of race, the rejection of rationalism, an emphasis on the organic and holistic — including environmentalism, health food, and exercise — and, most of all, the need to "transcend" notions of class': Goldberg (2007) 58–9.

on coming to power, declared May 1 a national holiday: Nazi Party members were ordered to address one another as ‘comrades’ (*Genossen*). His conception of the party was, like Lenin’s, that of a militant organization, a *Kampfbund*, or ‘Combat League’ ... His ultimate aim was a society in which traditional classes would be abolished, and status earned by personal heroism. In typically radical fashion, he envisaged man re-creating himself: ‘Man is becoming god ... Man is god in the making’.<sup>20</sup>

## 40. Nazism and Religion

Neo-atheists sometimes try to suggest that Hitler was a religious person. While it is true that Hitler often referred to ‘God’ or ‘providence’ in political writings and speeches, he was not appealing to the Judeo-Christian deity. Rather, he equated ‘natural law’ with the ‘survival of the fittest’ and God with ‘the unknown, or Nature, or whatever name one chooses’.<sup>21</sup>

Although Hitler grew up a nominal Roman Catholic, he rejected from an early age Catholic teaching, regarding Christianity as a religion fit only for slaves.<sup>22</sup> He firmly believed that the ramparts of religious belief had been overrun by the swift rush of science. He saw evolutionary ‘science’ as a vital element in the task of discrediting Christianity,<sup>23</sup> thus considering biological evolution the foremost weapon against traditional religions.

Hitler was of the opinion that ‘the heaviest blow that ever struck humanity was the coming of Christianity’.<sup>24</sup> He regarded the churches as the strongest and toughest reservoirs of ideological opposition against National Socialism.<sup>25</sup> Even so, in a conversation which took place only one year after the Nazi seizure of power, in 1933, Hitler stated also how liberal Christians could be ‘useful idiots’:

The religions are all alike, no matter what they call themselves. They have no future — certainly none for the Germans. Fascism, if it likes, may come to terms with the Church. So shall I. Why not? That will not prevent me from tearing up Christianity root and branch, and annihilating it in Germany ... But for our people it is decisive whether to acknowledge the Jewish Christ-creed with its effeminate pity-ethics, or a strong, heroic belief in God in Nature, God in our own people, in our destiny, in our own blood ... Leave the hair-splitting to others. Whether it’s the Old Testament or the New, or simply the sayings of Jesus ... it’s all the same old Jewish swindle. It will not make us free. A German Church, a German Christianity, is a distortion. One is either a German or a Christian. You cannot be both. You can throw the epileptic Paul out — others have done so before us. You can make Christ into a noble human being, and deny his role as a saviour. People have been doing it for centuries. I believe there are such Christians to-day in England and America ... We need free men who feel and know that God is in themselves.<sup>26</sup>

According to Hitler, religious virtues such as love, mercy and modesty, committed as they were to compassion and protection of the weak, were hindrances to the merciless, militaristic Aryan-race model. They were perceived as unacceptable obstacles to the propagation of the

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<sup>20</sup> Pipes (1997) 260.

<sup>21</sup> A Hitler, *Hitler’s Table Talk, 1941–1944* (1988) 6, 44.

<sup>22</sup> A Bullock, *Hitler and Stalin: Parallel Lives* (1992) 381.

<sup>23</sup> M Hawkins, *Social Darwinism in European and American Thought 1860–1945* (1997) 283.

<sup>24</sup> T Dowley, *A Lion Handbook: The History of Christianity* (1997) 589–90.

<sup>25</sup> R Evans, *The Third Reich in Power* (2005) 256.

<sup>26</sup> P Johnson, *The Intellectuals* (1988) 57.

strong and the exaltation of ‘action’ as the highest ideals of National Socialism.<sup>27</sup> Inspired by the philosophy of Friedrich Nietzsche (1844–1900), Hitler supported rather the idea of two types of morality: master and slave. The slave morality was basically a product of Judeo-Christian values. The master morality, by contrast, was representative of the allegedly higher ranks of ‘superior’ individuals. By applying the latter he believed he was setting people free to create a more evolved humanity through the process of natural selection. He gave each of his soldiers a copy of Nietzsche’s works.

Hitler believed the German people needed to rediscover their ‘pre-Christian authenticity’. He was trying to overthrow the entire millennium-old Judeo-Christian order to restore the paganism of antiquity.<sup>28</sup> So he ordered Germans to stop celebrating Christmas, and forced children from the Hitler Youth to recite a daily prayer to him for all their ‘blessings’. Not surprisingly, Hitler blamed the Jews for having invented Christianity,<sup>29</sup> thus requiring as a remedy that Germans be ‘immunised against this disease’.<sup>30</sup> According to United States Justice Robert Jackson (1892–1954), the Chief Prosecutor at the main Nuremberg Trial, the Nazis carried out ‘a systematic and relentless repression of all Christian sects and churches’.<sup>31</sup> Hitler had created, indeed, a final solution for the ‘problem’ of Christianity, again invoking liberal theologians as useful idiots:

What is to be done, you say? I will tell you: We must prevent the churches from doing anything but what they are doing now, that is, losing ground day by day. Do you really believe the masses will ever be Christian again? Nonsense! Never again. That tale is finished. No one will listen to it again. But we can hasten matters. The parsons will be made to dig their own graves. They will betray their God to us. They will betray anything for the sake of their miserable little jobs and incomes.

What can we do? Just what the Catholic Church did when it forced its beliefs on the heathen: preserve what can be preserved, and change its meaning. We shall take the road back: Easter is no longer resurrection, but the eternal renewal of our people. Christmas is the birth of *our* saviour: the spirit of heroism and the freedom of our people. Do you think these liberal priests, who have no longer a belief, only an office, will refuse to preach *our God* in their churches? I can guarantee that, just as they have made Haeckel and Darwin, Goethe and Stefan George the prophets of their ‘Christianity’, so they will replace the cross with our swastika. Instead of worshiping the blood of their quondam saviour, they will worship the pure blood of our people. They will receive the fruits of the German soil as a divine gift, and will eat it as a symbol of the eternal communion of the people, as they have hitherto eaten the body of their God. And when we have reached that point ... the churches will be crowded again. If we wish it, then it will be so — when it is *our* religion that is preached there. We need not hurry the process.<sup>32</sup>

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<sup>27</sup> Hambloch (1939) 14.

<sup>28</sup> Goldberg (2007) 61–2

<sup>29</sup> Hitler believed the apostle Paul had planned a ‘world revolution’ to overthrow the Roman Empire. In spite of his abandonment of the old faith, Paul would have continued to act on behalf of the Jewry.

<sup>30</sup> Hitler (1988) 217.

<sup>31</sup> R Jackson, *Nuremberg Trial Proceedings*, vol 2, The Avalon Project at the Yale Law School. Sir Winston Churchill, in his famous October 5 1938 speech in the British Parliament, declared: ‘There can never be friendship between the British democracy and the Nazi power, that power which spurns Christian ethics, which cheers its onward course by a barbarous paganism, which derives strength and perverted pleasure from persecution, and uses, as we have seen with pitiless brutality, the threat of murderous force. That power cannot be the trusted friend of the British democracy’: cited in V Adams, *Men in Our Time* (1969) 77.

<sup>32</sup> Raushning (1939) 58.

Because the most radical and influential leaders of the Nazi movement explicitly objected to Christianity in its very essence,<sup>33</sup> they wished to replace it with a national religion that was intended to supersede the Christian religion and its ideas of sin, penitence, and grace.<sup>34</sup> The German people would adore a man-god in the place of the God of the Bible, and abide by the paganism of nature-worship as a substitute for the ‘Jewish bondage of law’.<sup>35</sup> According to Professor Ernst Bergmann, a Nazi intellectual, the Germans should follow the ideals of ‘honour’ and not compassion; of ‘eternal struggle’ and not peace.<sup>36</sup> In his opinion, the most important thing was to give up the ‘superstition’ that people are sinful, and instead develop a new faith ‘in which we are ourselves Christ’. Influenced by the ‘forces of evolution’, the new ‘Christ’ would be ‘re-born in the womb of Mother-earth’; but not to be the Redeemer of the world, ‘for the world is in no need of redemption’.<sup>37</sup> Professor Bergmann concluded: ‘Destroy the legend of God become man and man himself shall rise up as God, as Christ; he shall become conscious of himself as such, and his essence shall take on the divine form’.<sup>38</sup>

But it is also true that many Germans who professed to be Christians made shameful efforts to compromise with Nazism. Needless to say, these ‘German Christians’ were determined to adopt an opposite meaning to real Christianity. They rejected all Jewish aspects of the Christian religion, particularly the Old Testament, and interpreted ‘God’ as some kind of super-Hitler on an extended scale. Finally, they elevated the leaders of Nazism to the position of final interpreters of the divine will. Of course, this sort of ‘Christianity’ had nothing to do with traditional Christian teaching but rather was an unpredicted by-product of liberal Protestant theology. According to J S Conway, Professor Emeritus of History at the University of British Columbia:

The leaders of the [German Christian] movement, Pastors Julius Leutheuser, Joachim Hossenfelder and Siegfried Leffler, strove to convince their fellow clergy that only a completely new interpretation of Christianity ... could meet the needs of the new age. They sought to rid the Church of its ‘pre-scientific’ mentality and its archaic liturgies, and to substitute a new revelation as found in Adolf Hitler. The essential was not Christian orthodoxy but Christian activism that would follow the example of the ‘heroic’ Jesus ... In the new creation of the Nazi Party, they saw a vehicle for their programme that offered

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<sup>33</sup> For instance, in his record of the 1961 trial of Karl Adolf Eichmann (1906–62), who was one of the principal architects of the Nazi Holocaust, Israeli prosecutor Gideon Hausner stated: ‘Eichmann was fanatically hostile to religion. Once, under my cross-examination, he admitted that he became so infuriated at seeing his wife reading a Bible that on two occasions he snatched the book from her hands and tore it to pieces ... He remained steadfast to the Nazi concept of God, which was represented by the power of Nature and reflected in the biological world. There was no room for morality, Jewish or Christian, in the world he believed in’: G Hausner, *Justice in Jerusalem* (1966), 9. At his trial, Eichmann’s main defence was that he was only a subordinate lieutenant-colonel and as such he was just obeying ‘superior orders’.

<sup>34</sup> W Shirer, *The Rise and Fall of the Third Reich* (1960) 240.

<sup>35</sup> A Kolnai, *The War Against the West*, London (1938) 241.

<sup>36</sup> *Ibid* at 238. Professor Bergmann wrote an important book entitled *Die 25 Thesen der Deutschreligion*, Breslau, 1934. In this book, he set up a Nazi religion for German schools that was based on pantheism, subjectivity, nature-worship, and ‘Volk’ instincts, via the romantic school of the French philosopher J J Rousseau. Professor Bergmann called his thesis a catechism of the German Religion: P R E Viereck, *Metapolitics: From Wagner and the German Romantics to Hitler* (2004) 292.

<sup>37</sup> Kolnai (1938) 246.

<sup>38</sup> *Ibid* at 267.

fellowship which they believe to be characteristic of true Christianity. If Hitler could perform what they called Christian deeds, then orthodoxy could be abandoned.<sup>39</sup>

As for the numerous attacks levelled against Christianity by Nazi leaders, these ‘German Christians’ consoled themselves with the fact that such hostility emanated only from individual representatives of the Party. Thus, in April 1937, a Rhenish group of ‘German Christians’ published a resolution which substituted Hitler’s authority for that of the Bible. The resolution stated: ‘Hitler’s word is God’s law; the decrees and laws which represent it possess divine authority. The *Führer* being the only *hundred per cent* National Socialist, he alone fulfils the law. All others are to be regarded as guilty before the divine law’.<sup>40</sup>

Those ‘Christians’ had embraced a ‘paganised’ form of Christianity that freed them from any moral implications of the Judeo-Christian faith. They practised a form of pagan amorality that was based on the worship of power and self under a more or less transparent ‘Christian’ cover.<sup>41</sup> They postulated that Christ had not come to reconcile sinners to God and the moral law but rather ‘to rescue them from the pressure of His demands and pretensions’.<sup>42</sup> Therefore, any attempt to overcome ‘the evil in us’ was deemed out of question, because the pursuit of ‘righteousness’ was interpreted as being incompatible with the sinful condition of human beings. According to the ‘German Christian’ Wilhelm Stapel, a prolific German theologian who thought each nation was entitled to possess its ‘own ethics’:

Redemption has as little to do with moral elevation as it has with worldly wisdom ... The Christian knows it is strictly impossible for him to ‘live’ except in sin; that he can form no decision without falling into unrighteousness; that he cannot do good unless doing evil by it at the same time ... God has made this world perishable, it is doomed to destruction. May it, then, go to the dogs according to its destiny! Men who imagine themselves capable of bettering it, who want to create a higher morality, are starting a ridiculous petty revolt against God.<sup>43</sup>

## 41. Nazism and Social Darwinism

Since Charles Darwin (1809–1882) believed that humans evolved from animals by means of a blind process of natural selection, three chapters of his *The Descent of Man*<sup>44</sup> are devoted to the theory that the mental and moral faculties of human beings originate from the same fount as that of animals. In his book, Darwin argues that the survival of the fittest is the engine for progress for humans as well as the rest of the animal kingdom, thus warning that measures should be taken to ‘prevent the reckless, the vicious and otherwise inferior members of society from increasing at a quicker rate than the better class of men’.<sup>45</sup> Deeply fallacious and racist as they are, these arguments made a profound impact upon social-science disciplines such as psychology, anthropology and law. According to law professor Phillip E Johnson:

Because Darwin was determined to establish human continuity with animals, he frequently wrote of ‘savages and lower races’ as intermediate between animals and civilized people. Thanks to Darwin’s acceptance of the idea of hierarchy among human societies ... the spread

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<sup>39</sup> J S Conway, *Nazi Persecution of the Churches, 1933–1945* (2001) 11.

<sup>40</sup> Kolnai (1938) 276.

<sup>41</sup> *Ibid* at 249.

<sup>42</sup> *Ibid* at 249–50.

<sup>43</sup> *Ibid* at 256–7.

<sup>44</sup> C Darwin, *The Descent of Man* (1871).

<sup>45</sup> *Ibid* at Ch 5.

and endurance of a racist form of social Darwinism owes more to Charles Darwin than to Herbert Spencer.<sup>46</sup>

The second half of the nineteenth century has been called the Darwinian Age.<sup>47</sup> In that period of time many social theorists (Ammon, Grant, Gumpłowicz, etc.) interpreted sociological facts in accordance with biological assumptions. The underlining biological assumption adopted by these theorists was that the process of ‘natural selection’ among the animal species also takes place among the human races. It is argued that such assumptions may have shaped racial-biological theories that ultimately culminated in the breeding and extermination policies of the Third Reich.<sup>48</sup>

In Germany, the main scientist to spread Darwinism was the prestigious biologist Ernst Haeckel (1834–1919). Darwinism became enormously popular in educated German circles due mainly to his scientific works. Haeckel was a close friend and supporter of Darwin and also the founder of the Association for the Propagation of Ethical Atheism. On March 8 1907, Kaiser Wilhelm II bestowed on him the title of Excellency, ‘in honour of his golden jubilee as a doctor’.<sup>49</sup> As the main promoter of Darwinism in Germany, Haeckel, among other things, advanced a theory of recapitulation which proposed that embryos of the different species resemble one another. It was later found that he made gross forgeries in those drawings, apparently to reinforce the assumption that humans, fish and chicken embryos were similar in nature. Some parts of the embryos he completely removed, whereas others he had deliberately distorted.

At the same time as he was eagerly fabricating those ‘evidences’ for Darwinism, Haeckel also assisted in spreading the principles of eugenics in Germany.<sup>50</sup> He considered, among other things, that the elimination of disabled children would assist to speed up the process of evolution. In fact, Haeckel went further, suggesting that all the mentally retarded and the genetically sick should be eliminated. For him, these human beings were just a great burden for society. He accused them of slowing down the process of evolution.

Haeckel died in 1919 but the Nazis inherited many of his ‘scientific’ ideas. For instance, a short while after reaching power, the Nazis introduced eugenics laws based on the biological policies advocated by Haeckel. As a result, the mentality ill, the disabled, and anybody having a serious hereditary disease was collected and transported to sterilisation centres. They were deemed social parasites and sterilised by such methods as castration, x-rays, injection, and electric shocks to the genital area.<sup>51</sup>

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<sup>46</sup> P E Johnson, *Objections Sustained* (1998) 35–6.

<sup>47</sup> Hambloch (1939) 14.

<sup>48</sup> *Ibid.*

<sup>49</sup> R Grigg, *The Trial and Death of Adolf Eichmann* (2009): see <<http://www.creation.com/the-trial-and-death-of-adolf-eichmann>> at 3 March 2009.

<sup>50</sup> In England the heads of the eugenics movement were Charles Darwin’s cousin, Francis Galton, and his son, Leonard Darwin.

<sup>51</sup> Kenneth Ludmerer, a medical historian at Washington University, has noted that the idea of eugenics is as old as Plato’s Republic. However, he argues also that Darwinism was the main reason for the rise in interest in the idea in the nineteenth century: ‘Modern eugenics thought arose only in the nineteenth century. The emergence of interest in eugenics during that century had multiple roots. The most important was the theory of evolution, for Francis Galton’s ideas on eugenics — and it was he who created the term ‘eugenics’ — were a direct logical

It is undoubtable that Haeckel's evolutionist theories provided the necessary biological basis for all the racist policies of National Socialism. For Hitler, evolution was the hallmark of modern science and culture.<sup>52</sup> The title of his book, *Mein Kampf*, is clearly an expression of that belief.<sup>53</sup> In fact, Hitler framed the entire National Socialist mission in terms of a self-conscious attempt to organize a nation according to a bio-policy that was supposedly congruent with the scientific assumptions of evolutionary 'science'.<sup>54</sup>

While Darwinism is obviously not the sole explanation for Nazism, it is nonetheless an essential one. Darwinism underpinned the most distinctive and essential features of National Socialism. According to the late British biologist Sir Arthur Keith (1866–1955), at one time a leading evolutionist in Great Britain, 'the German *Führer* [was] an ardent evolutionist that consciously [sought] to make the practice of Germany conform to the theory of evolution'.<sup>55</sup> There is indeed a clear correlation between the evolutionist worldview of the Nazis and the policies they implemented. This is a worldview in which race occupies a central role, and the struggle for survival is the *sine qua non* of life.<sup>56</sup>

The Nazis believed they were progressives who were advancing 'evolution' by conferring on the blind forces of nature the perfect sight of the Aryan; the better for its guiding principle of 'survival of the fittest' to see in which direction to go. Hitler thought that the highest good in community is to cooperate in the evolutionary progress of humanity.<sup>57</sup> He was able to justify any act of immorality committed against anyone outside the German racial community, seeing it as perfectly justifiable so long as it contributed to the welfare of the so-called 'Aryan' race.<sup>58</sup> Within this view of reality, 'the law of the preservation of favoured races in the struggle of life' could sanction the elimination of all those regarded as low and mentally underdeveloped.

In this sense, Hitler drew from a bountiful fund of Darwinist thought to construct his racist theories.<sup>59</sup> In one of his favourite tirades, on the 'virtues' of vegetarianism, he advanced that 'the monkeys, our ancestors of prehistoric times, are strictly vegetarian'.<sup>60</sup> In October 1941, he said: 'There have been human beings, in the baboon category, for at least three hundred thousand years. There is less distance between the man-ape and the ordinary modern man than there is between the ordinary modern man and a man like Schopenhauer'.<sup>61</sup> As for educating Africans to become lawyers and teachers, Hitler rejected it as impracticable, saying it was 'a criminal lunacy ... to keep on drilling a born half-ape until people think they have made a lawyer out of him ... For this is training exactly like of a poodle'.<sup>62</sup>

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outgrowth of the scientific doctrine elaborated by his cousin, Charles Darwin': K Ludmerer, 'Eugenics', in M Lappe (ed), *Encyclopedia of Bioethics* (1978) 457.

<sup>52</sup> D Gasman, *The Scientific Origins of National Socialism* (1971) 168.

<sup>53</sup> Hambloch (1939) 47.

<sup>54</sup> G Stein, 'Biological Science and the Roots of Nazism' (1988) 76 (1) *American Scientist* 50, 52.

<sup>55</sup> Sir A Keith, *Evolution and Ethics* (1947) 230.

<sup>56</sup> Robert Clark, *Darwin: Before and After* (1958) 115.

<sup>57</sup> R Weikart, *From Darwin to Hitler: Evolutionary Ethics, Eugenics and Racism in Germany* (2004) 211.

<sup>58</sup> *Ibid* at 214.

<sup>59</sup> *Ibid* at 9.

<sup>60</sup> Hawkins (1997) 290.

<sup>61</sup> *Ibid* at 283.

<sup>62</sup> A Hitler, *Mein Kampf* (1974) 391.

According to Hitler, the two basic dynamics of life are hunger (which promoted self-preservation) and love (which preserved the species).<sup>63</sup> Thus, he argued that the natural conditions in which these two instincts are satisfied are limited, such that organisms have to struggle for space and resources. It is out of this ongoing struggle that Hitler saw 'evolution' taking place through the mechanism of 'survival of the fittest'.<sup>64</sup> The struggle for survival among individuals and human races is what should determine 'their value and their right to exist'.<sup>65</sup> The evolution of humans, he contended, also occurred through the struggle for existence to which all the animal species are subject. As Hitler put it:

The stronger must dominate and not blend with the weaker, thus sacrificing his own progress. Only the born weakling can view this as cruel, but he after all is only a weak and limited man; for if this law did not prevail, any conceivable higher evolution of organic living beings would be unthinkable.<sup>66</sup>

## 42. Nazi Legal Theory

The idea that human law is to be subject to certain principles of a higher law began to be more deeply challenged in the nineteenth century, particularly when Charles Darwin's theory of evolution was interpreted as an attempt to promote a worldview that is based on the non-existence of God. As a result, the idea of law began to be interpreted by many as a mere product of human will, essentially a result of force and social struggle.<sup>67</sup> Such legal theory that 'might makes right' may therefore be described in terms of 'a philosophy without metaphysics, an epistemology without certainty of truth, or a jurisprudence without an idea of right'.<sup>68</sup>

To strict positivists any law which in procedural terms can be properly enacted by the state must not be rendered invalid on account of its intrinsic injustice or immorality.<sup>69</sup> To deem as 'non-law' a law enacted by the state, because it may violate some basic principles of justice and morality, one needs to adopt a concept of law that is both material and substantive in content.<sup>70</sup> A concept of law that is both material and substantive in content is what we normally describe as 'natural law'. On this basis the evil laws of the Nazi regime should not be described as law in the full sense of the term, because they do not satisfy basic moral standards that are required for them. Indeed, St Augustine (354–430) would not state that the Nazis were lawful authorities but rather a 'gang of criminals'.<sup>71</sup>

During pre-Nazi Germany, the most important lawyer in the country was probably the Austrian-born jurist Hans Kelsen (1881–1973). He was a strict positivist who confined his whole legal analysis to a theory of positive law and to its interpretation. Kelsen was anxious to maintain the difference, even the contrast, between *just* and *legal*. However, as he himself

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<sup>63</sup> Hawkins (1997) 278.

<sup>64</sup> *Ibid* at 274.

<sup>65</sup> M Baggot, 'Darwin, Hitler, and the Culture of Death', LifeSiteNews: <<http://www.lifesitenews.com/ldn/2008/may/08050602.html>> at 6 May 2008.

<sup>66</sup> A Hitler, *Nation and Race* (1974).

<sup>67</sup> D Noebel, *The Battle for Truth* (2001) 232.

<sup>68</sup> H A Rommen, *The Natural Law: A Study in Legal and Social History and Philosophy* (1989) 35.

<sup>69</sup> R A Hughes et al, *Australian Legal Institutions: Principles, Structure and Organisation* (2003) 32.

<sup>70</sup> M Stolleis, *The Law under the Swastika* (1998) 5.

<sup>71</sup> *Ibid* at 6.

openly admitted, such radical separation of jurisprudence from legal science did not exist in Germany until the beginning of the nineteenth century. According to Kelsen, before the rise of the *German Historical School of Law*, ‘the question of justice was considered its fundamental problem by juridical science’.<sup>72</sup>

The Historical School of Law emphasised the historical limitations of the law and stood in opposition to natural law, thus paving the way for the emergence of strict positivism in Germany. Based mainly on the writings and teachings of Friedrich Carl von Savigny (1779–1861), the basic premise of this school is that law is the mere expression of particular convictions of a people; that it is solely grounded in a form of popular consciousness which Savigny and others members of this school called the *Volksgeist*. The *Volksgeist* arguably evolves in an organic manner over time so that the ever-changing needs of society would properly justify the continuous, organic evolution of the law.

But the theorists of the Historical School also opposed the positivist conception of the political apparatus as a formal legal person. Generally speaking, they contended that the state is not a formal construct of the law but rather a corporation ‘comprising and evolving from a great number of legal agreements formed between distinct smaller corporations’.<sup>73</sup> Curiously, however, it appears that the German historical movement quickly degenerated in a school of jurists whose work culminated in a form of legal positivism.<sup>74</sup> Arguably, their call to historical exploration of German law led not only to a German historical jurisprudence, but also to a conception of law which appealed directly to nationalistic lawyers concerned to assist in the juridical unification of their politically fragmented nation. A positivistic approach to law was then developed in order to establish a new national legal system based on a network of positive norms ‘built from the abstractions distilled out of classical Roman sources’.<sup>75</sup>

As a strict positivist, Kelsen contended that legal norms are valid not by virtue of their substantive content, but only as positive commands that are enacted by the proper authority and in accordance with their formal legislative proceeding. Underlying this legal analysis is the assumption that law exists only as a formal system of positive rules and procedures. Hence, any content of law is valid provided it satisfies certain formal requirements. As Kelsen put it, there should be ‘no human behaviour which could not function as the content of a legal norm. A norm becomes law only because it has been constituted in a particular fashion, born of a definite procedure and a definite rule’.<sup>76</sup> Thus, his pure theory of law was concerned only to reveal the state legal system as it stands in a given time, ‘without legitimising it as just or disqualifying it as unjust; it seeks the real, the positive law, not the right law’.<sup>77</sup>

When the Nazis came into power in 1933, Kelsen, who was a Jew, was forced out of his post as Dean of the Law Faculty at the University of Cologne.<sup>78</sup> In the years following World War

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<sup>72</sup> H Kelsen, *General Theory of Law and State* (1946) 391.

<sup>73</sup> J Seitzer and C Thornhill, ‘An Introduction to Carl Schmitt’s Constitutional Theory; Issues and Context’, in C Schmitt, *Constitutional Theory* (2008) 12.

<sup>74</sup> J M Kelly, *A Short History of Western Legal Theory* (2007) 324.

<sup>75</sup> *Ibid* at 324.

<sup>76</sup> H Kelsen, ‘The Pure Theory of Law — Part 2’ (1935) 51 *Law Quarterly Review* 17, para 29.

<sup>77</sup> Bracher (1970) 474.

<sup>78</sup> Kelsen moved to the United States in 1940, becoming in 1945 a full professor at the department of Political Science at the University of California, Berkeley.

II, however, it was suggested that his legal theory would have provided no satisfactory legal recourse to resisting the Nazi regime. On the contrary, his theory might have even conferred a certain degree of validity on the evil laws of Hitler's Third Reich. For instance, in proposing the rigid separation of 'is' and 'ought' from legal analysis, Kelsen appears to have actually promoted the expulsion of ethics and metaphysics from jurisprudence.<sup>79</sup>

According to the American law professor and Catholic apologist Charles Edward Rice, when the Nazis moved against the Jews, German lawyers who opposed the Nazi regime were 'disarmed' by legal positivism.<sup>80</sup> Rice contends that this would not have been the case had most of the legal profession not embraced a rigid form of positivism, but had instead responded to the early Nazi injustices with a sound and 'principled denunciation' rooted in traditional principles of natural law. During that time, however, most German judges and lawyers were strict legal positivists who utterly rejected the idea of 'inalienable rights' as defined by classical natural-law theory. Instead, those judges and lawyers, Jeffrey Seitzer and Christopher Thornhill explain:

... tended to emphasize the close relation between legal analysis and the natural sciences. They argued that the evolution of law should be viewed as following purely positive patterns, and that law should be constructed as an internally and systemically consistent unity of principles and norms, relatively closed against normative, purposive, or directly politicized external input. Legal prescriptions, in consequence, should be viewed as nothing more than inner-judicial facts, constructs formed by the law itself to facilitate its own application. On these grounds, they concluded that the validity of law depended on its status as an internally consistent set of rules, and it could not be reconstructed or interpreted on the basis of moral prescriptions.<sup>81</sup>

Just after World War II, the highly respected German jurist Gustav Radbruch (1878–1949), who had been briefly Minister for Justice under the Weimar Republic, and was at the end of his life involved in the drafting of the 'Basic Law' for the new German Federal Republic, made also the claim that a prevailing form of strict positivism helped pave the way for National Socialism.<sup>82</sup> Radbruch believed, J M Kelly comments:

... the doctrine that law was whatever a statute said had rendered German justice helpless when confronted with cruelty and injustice once those wore statute vesture ... In his own reaction and in that of others, Radbruch saw a revival of belief in a transcendent law [however one may like to describe it: the law of God, the law of nature, the law of reason] by which evil positive laws may be condemned as 'legal injustice'. He ended his final lecture by reminding his students that, once upon a time, the title of this course [i.e., Legal Philosophy] in the syllabus had been 'The Law of Nature'.<sup>83</sup>

Regardless of whether or not Radbruch's opinion might be accurate, there is certainly little doubt that the vast majority of German lawyers were in fact hostile to the Weimar Republic, and so generally welcomed Hitler's appointment as Chancellor on 30 January 1933, as well

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<sup>79</sup> Hawkins (1997) 90.

<sup>80</sup> C Rice, 'Some Reasons for a Restoration of Natural Law Jurisprudence' (1989) 24 *Wake Forest Law Review* 539, 567.

<sup>81</sup> Steitzer (2008) 10.

<sup>82</sup> Lon Fuller in the 1950s and 1960s also advanced a natural law position in response to unjust Nazi positive laws: *The Morality of Law* (1964).

<sup>83</sup> Kelly (1992) 379.

as his subsequent consolidation of dictatorial power.<sup>84</sup> As evidence of this, more than 10,000 of them swore with their right arms raised in the Nazi salute, during the annual national convention of the German jurists in Leipzig, in October 1933, that ‘by the soul of the German people’ they would strive ‘to follow the course of our *Führer* to the end of our days’.<sup>85</sup>

Judges were undoubtedly supportive of the Nazi cause.<sup>86</sup> As a matter of fact, some of the regime’s most notorious laws and policies were proposed by them. As early as 1933, judges like Erich Schultze of the German Supreme Court were already supporting penalties for the ‘betrayal of the race ... that is ... the interbreeding of Germans with members of certain races named by law’.<sup>87</sup> Such judges discovered manifold possibilities for depriving Jews of their basic rights, even if no legal foundation for doing so existed.<sup>88</sup> In March 1933, the Federation of Judges declared its official support of and cooperation with the Nazi regime ‘in the revision of German law’.<sup>89</sup> The declaration included the following assurance: ‘German judges place their full confidence in the new government’.<sup>90</sup>

The attitude of subservience was reproduced by legal academics as well. According to Ingo Müller, ‘established professors were astoundingly productive during the early years of the Third Reich in helping to shape a ‘National Socialist legal system’. They saw it as their main task to bring about a ‘coordination’ of the legal profession parallel to the ‘coordination’ of legal institutions which had already occurred.’<sup>91</sup> For instance, Erik Wolf (1902–77), a professor who was appointed by Heidegger as Dean of the Faculty of Law at Freiburg University, argued that the courts should approach legal cases with a ‘healthy prejudice’, making value judgements which corresponded only to the National Socialist order and the will of its ‘political leadership’.<sup>92</sup> Thus, Professor Wolf warned judges that ‘in the everyday practice of law, genuine National Socialism is certainly best represented where the idea of the *Führer* is silently but loyally followed’.<sup>93</sup> He concluded:

A judge’s labours should not be constricted by arbitrary decisions or by a formalistic and abstract principle of stability of the law; rather [they should] find clear lines and ... wherever necessary, their limits through the legal views of the people that have found expression in the law and that are embodied by the *Führer*.<sup>94</sup>

In October 1933, the idea of ‘racial laws’ became the main subject of discussion during the annual conference of German law professors.<sup>95</sup> One of the speakers at the conference was

<sup>84</sup> I Müller, *Hitler’s Justice: The Courts of the Third Reich* (1991) 38.

<sup>85</sup> G Fieberg, *Justiz im Nationalsozialistischen Deutschland* (1984) 37, cited in Müller (1991) 38.

<sup>86</sup> Müller (1991) 38.

<sup>87</sup> ‘Richter und Staatsanwalt im Dritten Reich’ (1933) 280, cited in Müller (1991) 38.

<sup>88</sup> Müller (1991) 116.

<sup>89</sup> ‘Zeitspiegel’ (1933) 25 *Deutsche Richterzeitung* 258, cited in Müller (1991) 38.

<sup>90</sup> *Ibid* at 37.

<sup>91</sup> Müller (1991) 68–71.

<sup>92</sup> G Dahm, ‘Das Ermessen des Richters im Nationalsozialistischen Strafrecht’, *Deutsches Strafrecht* 1 (1934) 90, cited in Müller (1991) 73.

<sup>93</sup> E Wolf, *Das Rechtsideal des Nationalsozialistischen Staates* (351), cited in Müller (1991) 73.

<sup>94</sup> *Ibid* at 72.

<sup>95</sup> Hence, two years later the *Reichstag* introduced on 15 September 1935 its notorious ‘Law for the Procreation of German Blood and German Honour’, which prohibited the marriage between Jews and citizens of Germany or ‘related kinds of blood’. Marriages contracted in violation of that law were null and void. Two other laws were passed by the *Reichstag*, one depriving individuals ‘not of German blood’ of their rights as citizens’, and another prohibiting, among other things, marriages between Jews and citizens of German or related kinds of blood’: see *Law for the Protection of German Blood and German Honour*, 15 September 1935, at 8 September

Helmut Nicolai (1895–1955), a famous legal philosopher who published in 1920 a notorious book about the doctrine of racial laws (*Rassengesetzliche Rechtslehre*). There Professor Nicolai argued that ‘the most important task of legal policy is the struggle against racial dishonour’.<sup>96</sup> With so much display of racism and intolerance among those legal academics, it is no wonder that most of the articles published in law reviews displayed ‘a colourful mix of irrational fantasies, self-debasing declarations of submission, and traditional dogmatic jurisprudence with a ready (positivist) acceptance of the new legal order’.<sup>97</sup> Indeed, academic articles published at that time were completely dismissive of the idea of individual rights, a concept that was generally regarded as ‘a degenerate form of bourgeois constitutionalism’.<sup>98</sup>

Before assuming power, the Nazis were already proposing a plan in which the newborn with any physical or mental defect would have to be eliminated. Once in power, they enacted eugenics laws that claimed the lives of thousands of human beings. The great number of human exterminations, however, appears not to have affected the conscience of many legal academics. In fact, some of them were quite enthusiastic about the idea. In 1920, for instance, law professor Karl Binding (1841–1930) published a book in which he dismissed the possibility of any medical misdiagnosis as a matter of little concern. He wrote: ‘For family members the loss is naturally very severe, but the human race loses so many members to errors that one more or less hardly matters’.<sup>99</sup>

If we consider the 84 names on the 1922 membership list of the Association of Constitutional Lawyers, constitutional positivists were still dominant.<sup>100</sup> Alongside those positivists, as a second predominant group, were anti-positivists such as Rudolf Smend (1882–1975), who sought to apply the sociological concept of ‘integration’ to the political process.<sup>101</sup> By linking the quality of a state to a polity’s capacity for social integration, Smend’s ‘constitutional’ theory was clearly used to brand the Weimar state as a failed state that was incapable of satisfactory integration.<sup>102</sup> Although anti-positivist constitutionalists like Smend were in the centre of the opposition movement against the prevailing constitutional positivism, they shared with the latter a complete disregard for natural-law theory. These two groups were altogether dismissive of the whole Western tradition of modern constitutionalism.

In conformity to the *Volks-Nomos* (‘people-norm’) theory developed during the Nazi regime, constitutional-law professors denied the existence of any individual right against the absolute ‘right’ of the totalitarian state. In their legal view, law was not treated as a safeguard of the individual citizen held against governmental violence and oppression, ‘but another means of securing omnipotence for the Lords of the State ... In a word, the object of law was no longer

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2009. See also *The Reich Citizenship Law*, 15 September 1935, <<http://www.frank.mtsu.edu/~baustin/nurmlaw2.html>>.

<sup>96</sup> H Nicolai, *Rassengesetzliche Rechtslehre: Grundzüge einer Nationalsozialistischen Rechtsphilosophie* (1932) 46, cited in Müller (1991) 82.

<sup>97</sup> Stolleis (1998) 98–9.

<sup>98</sup> E Forsthoff, *Der Totale Staat*, 26, cited in Müller (1991) 71.

<sup>99</sup> K Binding and A Hoche, *Die Freigabe der Vernichtung Lebensunwerten Lebens* (1920) 40, cited in Müller, (1991) 121.

<sup>100</sup> Typical of this group were Richard Thoma, Heinrich Triepel, and Gerhard Anschütz.

<sup>101</sup> Smend worked it into a sociological theory of the Constitution on the basis of Theodor Litt’s philosophy of culture. In 1928 he published his book *Verfassung und Verfassungsrecht (Constitution and Constitutional Law)*, which made him famous among the intellectual elite: A Zimmermann, ‘Rudolf Smend e a Teoria Constitucional Integrativa’ (1998) 4 (1) *Cadernos de Estudos Constitucionais da PUC-Rio* 32–44.

<sup>102</sup> Stolleis (1998) 91.

to check but rather to encourage arbitrary exertion of public power'.<sup>103</sup> Naturally, as Ian Kershaw puts it, 'such interpretations by highly regarded legal theorists were of inestimable value in legitimating a form of domination which ... effectively undermined the rule of law in favour of arbitrary exercise of political will'.<sup>104</sup>

The correlation between the Nazi legal system and the disregard for basic human rights manifested itself most glaringly in the contribution of one of the most prominent constitutional lawyers of that time, Ernst Rudolf Huber (1903–1990). As a constitutional law professor at the University of Kiel, he advocated that it was 'impossible to measure the laws of the *Führer* against a higher concept of law', because 'in the *Führer* the essential principles of the *Volk* come into manifestation'.<sup>105</sup> As 'the executor of the nation's common will', Professor Huber argued that the power of the *Führer* was 'comprehensive and total', as a personalised political power that would have to remain 'free and independent, exclusive and unlimited'.<sup>106</sup> According to Huber, the rights of the 'national community' were always above the rights of the individual. In constitutional law, he concluded, the 'old formal-logical and normative thinking' of 'bourgeois' constitutionalism should be overcome by the new 'political communal thinking' of National Socialism.<sup>107</sup>

Another important contribution was that provided by Carl Schmitt (1888–1985). As the most important constitutional theorist of the Third Reich, Schmitt thought that traditional descriptions of the rule of law (*Rechtsstaat*) reflected only the 'self-deceiving' and 'weak-spirited' tendencies inherent in liberal constitutionalism. His most important and influential work had been written during the Weimar Republic. There, Schmitt describes constitutional law as both the form and the will of the state, to which all other laws must be subordinated.<sup>108</sup> Schmitt was a severe critic of the Weimar Republic, arguing that its constitutional order did not provide for a strong government, and as such for political stability. For Schmitt, the constitutional order of the Weimar Republic rested upon an utterly unconvincing faith in public argumentation and political openness.

Despite his apparent aversion to positivism, it is interesting to note that Schmitt retained strong ties to the German positivist tradition. His basic argument that the state is the sole origin of law, and that as such every legal system is always contingent on the will of the state, clearly does not contradict the positivist idea of law. As a matter of fact, his basic claim that laws cannot be made transparent to moral foundations actually places him in the terrain of legal positivism, at least with respect to his opinion about the relation between political power and legal norms. In arguing that laws are invariably subject to political contingences, and that therefore the political constitution is never determined by universal-ethical categories, Schmitt agreed with the positivist claim that 'law obtains legitimacy simply because of the fact that it has evolved into a certain positive form and that, supported by a

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<sup>103</sup> Kolnai (1938) 300.

<sup>104</sup> I Kershaw, *Hitler* (1991) 78.

<sup>105</sup> E R Huber, *Verfassungsrecht des Grossdeutschen Reiches* (2nd ed, 1939) 197: Cited in O Lepsius, 'The Problem of Perceptions of National Socialist Law, or: Was There a Constitutional Theory of National Socialism?', from C Joerges and N S Ghaleigh (eds), *Darker Legacies of Law in Europe: The Shadow of National Socialism and Fascism over Europe and its Legal Traditions* (2003) 25.

<sup>106</sup> Kershaw (1991) 78.

<sup>107</sup> E R Huber, 'Die Deutsche Staatswissenschaft', *Zeitschrift für die gesamten Staatswissenschaften* 95 (1935) 58–9, cited in Stolleis (1998) 73–4.

<sup>108</sup> Steizer (2008) 13.

state apparatus, it provides a concrete order of norms that shape and structure social expectations'.<sup>109</sup>

Curiously, Schmitt owed his own appointment to professorship at the University of Cologne largely to the efforts of Hans Kelsen. Soon afterwards, however, Schmitt helped drive Kelsen out of that university.<sup>110</sup> In May 1933, Schmitt officially joined the Nazi Party and soon after was appointed Law Dean at the prestigious University of Berlin. Within the Nazi-controlled organisation known as the Federation of the Guardians of the Law (*Rechtswahrerbund*), Schmitt had the opportunity to chair the section of university academics, where he served as the main editor of respected scholarly publications. There he published numerous essays claiming, among other things, that 'the whole of German law today ... must be governed solely and exclusively by the spirit of National Socialism ... Every interpretation must be an interpretation according to National Socialism'.<sup>111</sup>

Schmitt collaborated very actively with the Nazi regime between 1933 and 1936. Over that period he authored academic papers that fully supported some of the most dreadful policies of the regime.<sup>112</sup> While the Nazis were notorious for exacerbating popular resentments by appealing to the emotion of hate, Schmitt had actually developed in the 1920s a particular theory that could perfectly legitimise such base sentiments. Six years before the Nazi capture of power, Schmitt contended that law and morality were merely the products of a battle for political supremacy between hostile groups. In that same work he defined the concept of 'enmity' as the defining quality of politics. He wrote:

The specifically political distinction underpinning political actions and motives is that between *friend* and *foe*. It corresponds in the realm of politics to the relatively independent contrasts in other realms: between good and evil in ethics, the beautiful and ugly in aesthetics, and so on. The [distinction between friend and foe] is self-sufficient — that is, it neither derives from one or more of these contrasts nor is reduced to them ... [I]t can exist, both in theory and practice, without the concurrent application of other distinctions — moral, aesthetic, economic, and so on. The political enemy need not be morally evil or aesthetically ugly; he need not appear as an economic competitor, and it may even be very advantageous to do business with him. But he is the other, the stranger; and it is enough he is, in an especially intensive existential sense, someone different and alien, so that, in the event of a conflict, he represents the negation of one's own being, and for that reason must be resisted and fought in order to protect one's self-like (*seinmässig*) life-style.<sup>113</sup>

Under Art 48 of the Weimar Constitution, the President of the German Republic was authorised to rule by decree in times of emergency.<sup>114</sup> On the day following the burning of the Reichstag, on 27 February 1933, President Hindenburg used that article to sign into law

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<sup>109</sup> *Ibid* at 14.

<sup>110</sup> Müller (1991) 42.

<sup>111</sup> C Schmitt, 'Nationalsozialismus und Rechtsstaat' (1934) 63 *Juristische Wochenschrift* 713, cited in Müller, (1991) 60. After the war was finished Schmitt refused to admit any guilt concerning the Nazi regime's actions.

<sup>112</sup> Steizer (2008) 1.

<sup>113</sup> C Schmitt, (1927) 58 (1) *Archiv für Soziawissenschaft und Sozialpolitik*, cited in Pipes (1997) 263.

<sup>114</sup> These special powers remained in effect for four years, after which they could be renewed if the state of emergency had not ceased to exist. Whether or not fire was really set by the communists, the fact is that that section served the purposes of the declaration of a state of emergency.

the Reichstag Fire Decree.<sup>115</sup> What followed after the enactment of that decree was the complete loss of basic rights such as the right to freedom of speech and assembly, the inviolability of the home from unwarranted search, and even the right to own property. They were suspended ‘until further notice’.<sup>116</sup> For Schmitt, however, the suspension of these constitutional rights was not just normal but fully justified. In his book, *Political Theology* (1922), he contended that ‘the nature of state authority [was] revealed most clearly in the state of emergency. Here the decision making and the legal norm diverge, and ... authority proves that it need not have a basis in law in order to establish justice’.<sup>117</sup> Because a state of emergency authorised the government to suspend the entire legal order, he concluded that that Article provided extra-constitutional powers which were in principle without any legal limits. As Schmitt put it:

Once this state of emergency has been declared, it is clear that the constituted authority of the state continues to exist, which the law is placed in abeyance ... The decision exempts that authority from every normative restraint and renders it absolute in the true sense of the word. In a state of emergency, the constituted authority suspends the law on the basis of right to protect its own existence.<sup>118</sup>

Apropos, Schmitt also happened to be famous for his anti-Semitic rantings. In 1933, he organised a whole conference on the subject of ‘Jews in the Fields of Law and Economics’. At its opening section he declared: ‘The Jew’s relationship to our intellectual work is parasitical, tactical, and commercial ... Being shrewd and quick, he knows how to say the right thing at the right time. That is his instinct as a parasite and born trader’.<sup>119</sup> And a few months later, when a number of Jewish intellectuals were stripped of their citizenship and their books burned, he stated: ‘Intellectuals like these we can do without ... Germany has spit them out for all time’.<sup>120</sup>

When Schmitt fell slightly out of favour, in 1936, he attempted to regain prestige by supporting the suppression of ‘the enemy within’ the borders of Germany. From 1936 to 1945 he devoted himself to the area of international law. It was at that time that Schmitt developed the concept of *Grossraum* (‘large area’), which aimed to justify the subjection of neighbouring peoples. The concept was closely related to the notorious concept of *Lebensraum*, in which the Nazis claimed all territories outside the German borders as their natural sphere of influence.

Curiously, the more the legal community made efforts to legitimise the Nazi regime, the greater was the abuse and contempt with which it was greeted by the regime. First of all, Hitler didn’t think much of lawyers. Some of them later accepted the bitter realisation that they were deemed dispensable by the regime, including Schmitt himself. Hitler considered lawyers ‘defective by nature’, and was of the opinion that the foundations of the Nazi law lay

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<sup>115</sup> Its preamble declared: ‘As provided for by Article 48, paragraph 2 of the Constitution, the following is decreed to defend the state against Communist acts of violence ...’.

<sup>116</sup> Müller says, quite ironically, that ‘further notice’ did not occur until May 8 1945, when the decree was finally cancelled by the military government of the Allies – Müller (1991) 47.

<sup>117</sup> C Schmitt, *Politische Theologie* (2nd ed, 1934) 20, cited in Müller (1991) 46.

<sup>118</sup> *Ibid* at 181–2, cited in Müller (1991) 46.

<sup>119</sup> C Schmitt, ‘Die Deutsche Rechtswissenschaft im Kampf gegen den Jüdischen Geist’ (1936) *Deutsche Juristen-Zeitung* 1193, cited in Müller (1991) 43.

<sup>120</sup> C Schmitt, ‘Die Deutschen Intellektuellen’ (1933) 126 *Westdeutscher Beobachter* 1, cited in Müller (1991) 43.

wheresoever the *Volk* life or the present time was stirring. As Hitler himself declared: ‘The health of the German nation is more important than the letter of the law’.<sup>121</sup>

Initially, however, the Nazi regime took a strong interest in preserving the impression of legal ‘normality’. This façade was operated by the party’s endorsement of an ideological interpretation of law. As far as the legal system was concerned, the initial strategy was not to repeal the old legal system, but to deliberately distort its original meaning.

An important source of inspiration for the Nazi’s interpretation of law was the *Freirechtsbewegung* (‘Free Law Movement’), whose roots are found in a lecture delivered in 1903 by Eugen Ehrlich (1862–1922), and in an article published in 1906 by Hermann Kantorowicz (1877–1940) entitled ‘The Battle for Liberation of Legal Science’.<sup>122</sup> This German legal movement was in essence a rather fair reaction against the excessively literal and, as such, sometimes unjust adherence to the letter of the law.<sup>123</sup> Unfortunately, under the National Socialist regime the idea of departing from the strict language of statutory law, and looking instead at values, was taken to sinister extremes. In this kind of anti-literalist atmosphere, it was no wonder that even Gustav Radbruch, who had been first a staunch supporter of the Free Law Movement, and was after 1945 a vehement opponent of legal positivism, wrote in 1939 that the strict interpretation of law at least provided some kind of certainty, and therefore a protection from arbitrary oppression.<sup>124</sup>

In the Nazi system of domination, however, the legal system was understood in terms of a progressive order of community life and social evolution. It was not rigid but rather developed in continuous flow. In practice, it was quite clear that the Nazi legal system merely materialised the arbitrary decisions (‘decisionism’) of the holders of power. As one of the Nazi Party’s leading lawyers, Hans Frank (1900–1946)<sup>125</sup> stated: ‘The basis for the interpretation of all legal sources is the National Socialist ideology, particularly as expressed in the party program and the Führer’s statements’.<sup>126</sup>

From the beginning the Nazi regime placed great stock in the introduction of new principles of legal interpretation as a symbol of their ‘new thinking’. Since what really mattered was not the influx of new legislation but the interpretation of all existing laws according to the maxims of evolutionary thinking (and its resulting adaptation to the alleged needs of community), the Weimar Constitution was never formally abrogated by the Nazi regime. Rather than overruling the old constitutional order *en bloc*, the Nazis opted for adopting a method of legal interpretation that deliberately distorted the original nature of the legal system. As Michael Stolleis explains:

Disregard of original legislative intent by ideologically guided judges became far more significant in everyday legal life of National Socialism than injustice directly commanded by the lawmaker. And that is why the thesis disseminated in the 1950s — that the judiciary,

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<sup>121</sup> M Broszat, *The Hitler State* (1981) 293.

<sup>122</sup> In German, *Der Kampf um die Rechtswissenschaft*. See F K Carter, ‘Gustav Radbruch and Hermann Kantorowicz: Two Friends and a Book’ (2006) 7(7) *German Law Journal* 657, 658.

<sup>123</sup> Kelly (1992) 359.

<sup>124</sup> *Ibid* at 361.

<sup>125</sup> Hans Frank was Reich Minister without portfolio, Head of the National Socialist Bar Association (1933–42), member of the Reichstag, President of the International Chamber of Law (1941–42) and of the Academy of German Law, and Governor-General of the occupied Polish Territories (1939–45).

<sup>126</sup> H Frank, *Reichsgesetzblatt* (1933) 39, cited in Stolleis (1998) 14.

because of its positivist orientation, had been helpless in the face of a legislator liberated from all constraints — contained only part of the truth ... Already during the Weimar Republic, wide segments of the judiciary had chosen to oppose the democratically legitimized legislative body. That is why the Nazis' call to 'overcome narrow normativism' through legal interpretation ... no longer posed any problems of method ...

Both during the period of the seizure of power and during the war, interpreting the old law under the guidance of National Socialist ideology proved a superior approach than legislating new law. It was faster and more flexible, and in individual cases it could be more easily criticised and invalidated. The regime evidently accepted the fact that the vague nature of 'National Socialist ideology' in turn created some manoeuvring room, which was used in various ways. Actual laws, by contrast, had to be measured against National Socialism's own claims. They also developed a certain binding effect that was bothersome to the new rulers.<sup>127</sup>

The legal language behind those attempts to corrupt the law reveals that a basic objective of the Nazis was not to follow legality with the greatest possible precision, but to instead establish a subjective value for law, in accordance with the momentary aspiration of the 'national community'. In fact, the idea that the rights of the individual had to be restricted in favour of the 'community' assumed a prominent place in Nazi legal discussions. This was so because, as the Nazi jurist Paul Ritterbusch (1900–1945) put it, the National Socialist movement was the becoming-of-the-nation [*Volkswerdung*]. Such 'becoming' was none other than 'the fulfilling realisation of the truth and reality of our selves'. Thus, he concluded: 'The last becoming-of-the-nation fulfils the law of our reality and truth, for only the whole is true and real, and only the nation is the wholeness and therefore the truth and reality of our selves'.<sup>128</sup>

### 43. Conclusion

The Nazi legal system cannot be isolated, like some sort of accident, from the viewpoints of the powerful juridical elite in Germany. In that time, most German judges and lawyers were anxious to establish an authoritarian regime that was supported by a legal system which rejected any protection of individual rights against the state. They had been hostile to the Weimar Republic, and generally welcomed the Nazi regime in 1933. Such an attitude of support towards the Nazi regime was reproduced by the legal academics. In many respects, law professors played a decisive role in the decline of justice and legality during the Third Reich. Their contribution was of inestimable value in legitimating the totalitarian regime and its arbitrary exercise of political will. Indeed, it could even be argued that they provided a philosophical cloak for the murderous actions of the Nazi regime, which otherwise should have been recognised as unlawful.<sup>129</sup>

The ideology of National Socialism was forged primarily through the combination of a glorification of the all-powerful state through a nationalist type of popular socialism, with a pseudo-scientific form of social Darwinism. According to Nazi legal theory, humans are not special individuals endowed with certain unalienable rights, but merely creatures descended from the animal kingdom. Thus, it was assumed that 'superior' humans would have the

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<sup>127</sup> Stolleis (1998) 14–15.

<sup>128</sup> Ritterbusch, 'Der Führer und Reichskanzler, des Deutschen Volkes Staatsoberhaupt', *Juristische Wochenschrift* (1934) 2193–4, cited in Stolleis (1998) 80.

<sup>129</sup> *Ibid* n 93, p 78.

‘right’ to eliminate the ‘inferior’ ones, for the same reasons that lions eat antelopes. A ‘master morality’ therefore prevailed, and it became totally meaningless to appeal to any higher law or principle against such brutal tyranny; for to do so would be, in the Nazis’ naturalistic worldview, akin to telling lions that they should stop being lions.<sup>130</sup>

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<sup>130</sup> D D’Souza, *What’s so Great About Christianity* (2007) 221.

# **BANK MERGERS IN AUSTRALIA: THE PAST, THE PRESENT AND THE POSSIBLE FUTURE IMPACT OF THE GLOBAL FINANCIAL CRISIS**

**Leela Cejnar\***

## **Abstract**

This article provides an overview of the laws and policies that play a part in regulating bank mergers in Australia. In particular, the article focuses on the way in which bank mergers are treated under the *Trade Practices Act 1974 (Cth)* (*Trade Practices Act*).

In Australia, bank mergers are subject to assessment by the Australian Competition and Consumer Commission (ACCC) under the *Trade Practices Act*. The Federal Treasurer also has powers under the *Banking Act 1959 (Cth)* (*Banking Act*) to review, and if necessary, to prevent, mergers between banks.

In 2008, two significant bank mergers were allowed: Westpac Banking Corporation and the St George Bank Limited; and Commonwealth Bank of Australia and BankWest and St Andrew's Australia. Both mergers took place in the context of one of history's worst financial crises, raising concerns about whether, going forward, the Australian banking sector will see a shift in merger law and policy such that the importance of preserving financial stability will come at the cost of competition.

This article provides a historical overview of bank mergers that have taken place in Australia since 1995 and also considers the possible future impact of the global financial crisis, including the impact of 'rescue packages', on competition between the banks, and how this could affect bank mergers going forward.<sup>1</sup>

## **44. The Basis for Assessing Bank Mergers in Australia**

### **lxviii. Introduction**

In 2008, the Australian banking sector witnessed the merger between Westpac Banking Corporation (Westpac) and the St George Bank (St George). This was followed soon after by the merger between the Commonwealth Bank of Australia (Commonwealth) and BankWest. Both these mergers took place in the context of the present global financial crisis, prompting various statements from Prime Minister Kevin Rudd and his Treasurer, Wayne Swan, that the concern in Canberra was to preserve (Australia's) financial stability at all costs.<sup>2</sup> As such, questions have been raised as to whether the future of Australia's banking market, particularly in light of the fallout in the banking sector from the financial crisis, will be one

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\* Associate Lecturer, Macquarie University.

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<sup>2</sup> See <<http://www.abc.net.au/pm/content/2008/s2386927.htm>>: ABC Online, *Prime Minister Rudd's View on the Economy*, 9 October 2008, 6.10pm, reporter: Alexandra Kirk.

where there are few, if any, regional or small banks remaining, but instead four ‘goliaths’ left to dominate.

The crisis also raises questions about whether, in the face of a ‘banking breakdown’, it is possible to keep competition alive and well amongst the banks. To date, bank mergers in Australia have permitted growth, so long as the effect or likely effect of the merger or acquisition will not substantially lessen competition. Going forward, in the face of such a severe financial crisis, will the necessity to preserve economic stability result in pressure to allow bank mergers even though they may be anti-competitive?

This article reviews what has happened with bank mergers in Australia from 1995 until the present day and also considers the possible impact of the global financial crisis on merger law and policy in the Australian banking sector.

### **lxix. The ‘Big Four’**

In Australia the banking market is presently dominated by four big banks (and this has been the case for some years): the Commonwealth Bank; Westpac; the National Australia Bank; and the Australia and New Zealand Banking Group Limited (ANZ Bank) (known collectively as the ‘Big Four’).<sup>3</sup> There are also a number of smaller regional banks and non-bank financial institutions.

Bank mergers in Australia are subject to assessment by the Australian Competition and Consumer Commission (ACCC) under the *Trade Practices Act*. Section 50 of that Act prohibits mergers that would have the effect, or likely effect, of substantially lessening competition in a substantial market in an Australian state or territory. The Federal Treasurer also has powers under the *Banking Act* to review, and if necessary, to reject mergers under relevant Australian banking and insurance laws.

Mergers in the Australian banking sector are subject to prudential considerations and requirements by the Treasurer, who is guided by advice from the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investments Commission (ASIC). They are also subject to the ‘national interest’, and as such must satisfy a ‘public interest’ test. That is, in assessing merger applications, the Treasurer, pursuant to s 63(3A) of the *Banking Act*, is required to ‘take the national interest into account’ before giving his consent to a proposed acquisition.

If authorisation is sought for a proposed acquisition from interested parties, the ACCC will consider whether the proposed acquisition will result, or will be likely to result, in such a benefit to the public that the acquisition should be allowed to occur.<sup>4</sup>

Australian mergers laws and policies apply to mergers between the Big Four banks, between the Big Four and Australian regional banks, between banks and non-banks generally (for example, between banks and insurance companies) and potentially also between Australian

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<sup>3</sup> By way of background, the largest four participants in the New Zealand banking market are each wholly owned subsidiaries of the ‘Big Four’ Australian banks. They are ANZ National Bank Limited (owned by the ANZ Bank), Bank of New Zealand (owned by National Australia Bank), Westpac New Zealand Limited (owned by Westpac) and ASB Bank Limited (owned by the Commonwealth Bank).

<sup>4</sup> *Trade Practices Act 1974* (Cth) s 90(6).

banks and foreign banks. It is also important to note that under its ‘Four Pillars’ policy, to be discussed later in this article, the government does not allow mergers between the Big Four banks (see under the heading ‘The “Four Pillars” Policy’, below).

**Ixx. Bank mergers and the *Trade Practices Act 1974* (Cth)**

**aa. ‘Substantial Lessening of Competition’ Test**

Section 50 of the *Trade Practices Act* prohibits mergers that would have the effect, or likely effect, of substantially lessening competition in a substantial market in an Australian state or territory.

**bb. Statutory Factors**

Section 50(3) sets out a number of factors to be taken into account in determining whether a merger is likely to substantially lessen competition. These are:

- a) the actual and potential level of import competition in the market;
- b) the height of barriers to entry to the market;
- c) the level of concentration in the market;
- d) the degree of countervailing power in the market;
- e) the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;
- f) the extent to which substitutes are available in the market or are likely to be available in the market;
- g) the dynamic characteristics of the market, including growth, innovation and product differentiation;
- h) the likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor;
- i) the nature and extent of vertical integration in the market.

**cc. Previous ‘Dominance’ Test**

This position should be contrasted with the market ‘dominance’ test’ (which was the test applied in Australia from 1977 to 1993).<sup>5</sup> The ‘dominance’ test had the effect of enabling mergers to proceed, even if they substantially lessened competition in an Australian market,

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<sup>5</sup> In 1976, a detailed review of the *Trade Practices Act* was undertaken by the Trade Practices Review Committee (the ‘Swanson Committee’). Among other things, its terms of reference included whether it was desirable for the *Trade Practices Act* to contain a prohibition relating to anti-competitive mergers and, if so, what form that prohibition should take; further, if there was to be such a prohibition, whether it would be appropriate to make special provision for mergers involving failing companies and whether it would be appropriate and practicable to exclude mergers involving small companies, possibly by a threshold test. The committee reported on 20 August 1976 and most of its recommendations resulted in major amendments to the *Trade Practices Act* in 1977.

provided they did not result in the merged firm being in a position to control or dominate the relevant market. The change in this test was significant particularly for the banking sector. Under the previous 'dominance' test, mergers between banks were prohibited if they gave rise to a single firm being dominant or having a monopoly in a particular market.<sup>6</sup>

That said, a merger would not have been blocked if no single dominant firm would emerge out of the merger. While this test applied, bank mergers were difficult to block as post-merger, there were always some competitors left in the market.<sup>7</sup>

#### **dd. Market Definition**

In assessing mergers, a critical element of whether a merger will have the effect, or likely effect, of substantially lessening competition will include defining the relevant market, although there will also be other considerations in any competition analysis.

Market definition is not an end in itself, but rather an instrument to identify circumstances where there might be competition concerns. The most important objective of defining a market is to identify those competitors that in some way can constrain the exercise of market power of the firms concerned by providing customers of a relevant firm (or firms) with alternative sources for the product or service. In looking at market definition, the ACCC examines the following:

- *Product market*: A market is the area within which significant substitution in consumption or production occurs, based on the idea that the exercise of market power can be constrained by demand substitutability or supply substitutability. Those who supply the product, or who can readily shift into offering such a product, are in the market. Those who can make such an offering only after some time are not treated as market incumbents but their potential entry may nevertheless limit the power of the incumbents.
- *Demand substitution*: As far as demand substitution is concerned, competition agencies worldwide use the hypothetical monopolist test, the SSNIP test (small but significant non-transitory increase in price). This test asks whether the parties' customers would switch to substitutes in response to a 5–10% increase in price. If substitution would be sufficient to make the price increase unprofitable those substitutes are part of the relevant market.
- *Supply substitution*: Supply substitutability requires that an alternative supplier is able to switch production to the relevant product in response to the price increase.
- *Geographic market*: The geographic market, for the purpose of merger analysis, is defined as a substantial market for goods or services in Australia, a state, territory or region of Australia: s 50(6). The geographic market must also be an area from within which any substitute may come.

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<sup>6</sup> The s 50 which emerged in the *Trade Practices Amendment Act 1977* (Cth), No 81 of 1977, dealt only with acquisitions which resulted in or increased market dominance.

<sup>7</sup> On 1 June 1986, the *Trade Practices (Transfer of Market Dominance) Act 1986* (Cth), No 8 of 1986, came into operation. It amended s 50 by replacing the 'dominance test' with the present prohibition of acquisitions that would have the effect or likely effect of substantially lessening competition.

- *Functional market*: For any particular product or service, there may exist distinct vertical stages of production and/or distribution (for example, manufacturers, wholesalers and retailers), so that firms within the same industry may not be competitors in the same market. In other words, there may also be a functional dimension to a market.
- *Potential competition*: A properly defined market excludes potential suppliers: (1) whose product is too different (product dimension) or too far away (geographic dimension); and (2) who are not likely to shift promptly to offer the firm's customers a sustainable, proximate (in both product and geographic terms) alternative.
- *Changing markets in bank merger analysis*: The approach to analysing competition and market definition in the context of bank mergers has been complicated by changes in the market. The ACCC has itself changed market definitions in the past in many markets, including banking, as market circumstances have changed.

This approach has been further complicated with respect to banks by the broad range of banking products offered (for example, home loans, credit cards, personal loans, small business banking products, transaction accounts etc). Over time, this has resulted in the ACCC moving from what might be described as a 'cluster market' approach (see discussion under the heading 'Westpac/Challenge (1995)', below) to an 'individual market' approach, in trying to work out whether the market for banking products is a 'national' or 'state' one (see discussion under the heading 'Westpac/Bank of Melbourne (1997)', below).

More recently, there have been dramatic changes in financial markets resulting from the global financial crisis; sources of funds have been severely curtailed and some financial institutions have had deposits guaranteed while others have not, all these issues affecting the state of competition in the banking sector.

#### ee. **Market/Competition Analysis**

In carrying out a market or competition analysis in respect of a proposed merger, the ACCC will also consider wider competition issues, including the statutory factors set out in s 50(3) (see under the heading 'Statutory Factors', above). By way of example, in the Westpac/St George merger, some of the competition issues considered by the ACCC included the following.<sup>8</sup>

- **Barriers to large scale national entry for all retail banking products**: these barriers are high and almost all the new entry in recent years has come from large international financial institutions.
- **Regulatory barriers**: these are significant for authorised deposit-taking institutions and specialist credit card institutions, as both types of institutions are required to comply with a host of prudential regulations, including capital requirements.<sup>9</sup>

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<sup>8</sup> ACCC Public Competition Assessment Westpac Banking Corporation proposed acquisition of St George Bank Limited, 13 August 2008, p 10.

<sup>9</sup> Given their specialised nature, which may concentrate certain types of risks, locally incorporated SCCIs will normally be subject to a minimum capital ratio of 15% (or minimum dollar capital, whichever is higher), although this may be varied by APRA depending on the risk profile of the applicant. In addition, newly

- Current credit conditions: these have had the effect of raising barriers to entry for lenders; in particular, the closure of securitisation markets and the increase in the cost of credit has meant that many non-bank players have exited lending markets and some other players have ceased writing new loans in the interim.
- Relative increase in costs of funds: this may make it more difficult for the smaller financial institutions (with less favourable credit ratings) to compete in the short term.
- High degree of customer ‘stickiness’ for many retail banking products: this may further increase entry barriers; it is often difficult and time-consuming for a customer to compare one product with another. Even if a customer is aware of a product that is a ‘better deal’ in terms of price, the inconvenience and, in some cases, financial cost (for example, mortgage exit fees), may deter switching (and the ACCC noted that the Australian Government’s switching initiatives may act to somewhat reduce these barriers).<sup>10</sup>
- Dynamic characteristics of the market: the ACCC considered that the highly dynamic and technology-driven nature of this market means that new competitive threats are likely to emerge, as already evident in the availability of separately managed accounts (SMA) products.<sup>11</sup>
- Capital costs of establishing a strong national presence (or indeed even in one state).
- Barriers to expansion for existing players into new local markets.

**a. ACCC Merger Guidelines**

In June 1999, the ACCC published Merger Guidelines which set out its approach to assessments of acquisitions under s 50 as to what constitutes a substantial lessening of competition. On 21 November 2008, the ACCC released new Merger Guidelines. These 2008 guidelines replaced the 1999 Merger Guidelines and also supplement the ACCC’s Merger Review Process Guidelines for informal merger reviews issued in 2006; and the Formal Merger Review Process Guidelines issued in 2007. The Merger Guidelines have no legal basis or force in determining whether an acquisition contravenes the Trade Practices Act, as that is a matter for the Federal Court. They are intended to provide a guide for the Australian business community, its advisers and the general public as to when the ACCC is likely to wish to review a proposed merger and the ACCC’s approach in conducting that review.

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established SCCIs may also be subject to a higher minimum capital requirement in their formative years, depending on the risk profile of the proposed operations: Guidelines on Authorisation of Specialist Credit Card Institutions, APRA: see <<http://www.apra.gov.au/ADI/upload/Guidelines-on-Authorisation-of-Specialist-Credit-Card-Institutions.pdf>>.

<sup>10</sup> *Ibid* n 8, p 13.

<sup>11</sup> SMAs or separately managed accounts are a portfolio made up of securities that are beneficially owned by the individual investor and managed by professional managers.

## **b. Types of Merger Reviews**

In Australia, it is not mandatory to advise the ACCC of any proposed merger or acquisition, and ACCC clearance is not required before transactions are completed. However, given the potentially significant consequences that can arise if a merger is subsequently found to have contravened s 50, it is common for merger parties to seek ‘clearance’ from the ACCC before proceeding with a transaction.

Since 1 January 2007, there are three main avenues available to merger parties seeking ‘clearance’ to a proposed acquisition or merger under the Act. These are:

- to apply to the ACCC for an informal merger clearance under s 50;
- to apply to the ACCC for a formal merger clearance under s 50; or
- to apply to the Australian Competition Tribunal for merger authorisation (with the onus on the applicant to prove that the merger satisfies the ‘public benefit test’; namely, that the proposed acquisition would result or be likely to result in a benefit to the public and that the benefit would outweigh the detriment to the public constituted by any lessening of competition that would result or be likely to result: s 90(6).

## **c. Undertakings**

Parties may also offer court-enforceable undertakings under s 87B to alleviate the ACCC’s concerns about a merger. These undertakings are significant as the Federal Court can enforce s 87B undertakings without a review of the merits.

Section 87B was inserted into the Act in 1992 as a consequence of situations, particularly with mergers, where it was obvious the merger could be approved subject to certain conditions being met. However, prior to 1992 there was no mechanism in the Act through which the then Trade Practices Commission could enforce those conditions. As a result, on occasions mergers would be opposed because such conditions could not be enforced.

Since 1992, the ACCC has accepted a number of s 87B undertakings relating to mergers,<sup>12</sup> and in so doing has considered whether the undertakings are:

- necessary to remedy the problem created by the merger; and
- proportionate in the product, geographic and temporal dimensions to remedy the competition problems.

## **lxxi. The Treasurer’s Powers in Relation to Bank Mergers**

### **a. The ‘National Interest’**

As stated earlier, in making any decision about a banking merger, the Treasurer will, among other things, take into account the national interest, under s 63 of the *Banking Act*. This power originated in the context of the need for prudential regulation considerations in respect

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<sup>12</sup> See especially Westpac/Bank of Melbourne merger (1997) and Commonwealth Bank/Colonial merger (2000) discussed in Pt 2 of this article.

of bank mergers. As it stands, the Treasurer must consult with APRA and ASIC before giving his consent to a merger.

Bank mergers are therefore subject not only to prudential requirements but are also considered in the wider context of ‘the national interest’, and as stated earlier, are subject to a ‘public interest’ test. There is no indication in the *Banking Act* as to what constitutes ‘the national interest’.

#### **b. The ‘Four Pillars’ Policy**

In terms of government policy, it is important to note what is known as the ‘four pillars’ policy (which is based on the Treasurer’s power under s 63 of the *Banking Act*). The policy actually began as the ‘six pillars’ policy in 1990 when the then Labor Government announced that no mergers would be allowed between any of the four major banks and two major life insurance companies<sup>13</sup> — the six pillars of the Australian financial system. It became the ‘four pillars’ policy when the Howard Government announced its response to the final report of the Financial System Inquiry (the Wallis Inquiry) in 1997. Under this policy, mergers among the four major banks will not be permitted until the government is satisfied that there is improved competition from new and established financial industry participants, particularly with regard to small business lending.

It should be pointed out that the ‘four pillars’ policy in relation to the four major Australian trading banks only relates to mergers. Other commercial arrangements or agreements between the Big Four banks, including joint ventures, are subject to the application of trade practices law.

In October 2008, Labor Government Treasurer Wayne Swan announced that the Rudd Government remains committed to maintaining the ‘four pillars’ policy.<sup>14</sup> The Treasurer has said that in exercising the reserve power to reject other mergers under relevant banking and insurance laws, he will take into account the assessment of the ACCC on competition effects.<sup>15</sup>

However, in recent months, the preservation of confidence in the banking system seems to have superseded the government’s commitment to the ‘four pillars’ policy. On 9 October 2008, Prime Minister Rudd, in an interview broadcasted by ABC radio, said that in ‘... an apparent conflict between stability and competition right now, this Prime Minister and the Treasurer ... will be backing stability first and foremost. Competition questions can be resolved over time’.<sup>16</sup>

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<sup>13</sup> The ‘six pillars’ policy covered the Big Four banks, the Commonwealth, ANZ and National Australia Banks and Westpac and the two insurers, AMP and National Mutual. It was essentially designed to block the merger between ANZ and National Mutual at the time.

<sup>14</sup> See <<http://www.abc.net.au/pm/content/2008/s2262877.htm>>: ABC Online, *Four Pillar’s Here to Stay* — Wayne Swan, 2 June 2008, 6.44pm, reporter: Stephen Long.

<sup>15</sup> *Ibid.*

<sup>16</sup> See <<http://www.abc.net.au/pm/content/2008/s2386927.htm>>: ABC Online, *Prime Minister Rudd’s View On the Economy*, 9 October 2008, 6.10pm, reporter: Alexandra Kirk. Also on 9 October 2008, in an interview about the Global Financial Crisis with Kerry O’Brien on the ABC TV’s *7.30 Report*, Prime Minister Rudd re-iterated his point by saying: ‘... the reality is, in the middle of a global financial crisis it is my job as Prime Minister to defend the stability of the financial system ...’.

Whether this means the ‘four pillars’ policy may ultimately be overridden to preserve the stability of Australian banks during this period of global financial uncertainty remains to be seen. Although there is no actual consideration at present of the Big Four banks being allowed to merge, the government’s recent attitude to the takeover of the St George Bank (a significant regional bank) by Westpac (one of the ‘Big Four’) is a possible cause for concern regarding the future of regional banks in Australia and the possible takeover of other regional banks by the Big Four. However, in that instance, the ACCC had not objected to the acquisition under s 50 of the Act, so that it was perhaps too much to expect the government to block it.

### **Ixxii. Major Inquiries into the Australian Financial System**

In the early days of Australian banking history, there was no central bank. Each private bank stood or fell on its own credit. As long as a bank’s assets were believed to be sound, its notes would be freely accepted. Banking became more tightly controlled during World War II, with the central bank dictating overdraft rates and, later, statutory reserve deposit ratios and liquid asset ratios.<sup>17</sup> In 1959, when the Reserve Bank of Australia (RBA) was created, the Commonwealth Bank’s central banking powers were transferred to the RBA.<sup>18</sup> In this era, banking remained tightly controlled, but safe.

As the post-war boom of the 1950s developed, the banks formed finance companies or invested in them and became players in this rapidly expanding market. The finance companies began lending to the corporate cowboys of the era. A whole fringe banking system began to emerge. The licensed banks were still controlled, but finance companies, merchant banks, foreign banks and (to a large degree) state banks were not subject to RBA supervision.

In the 1970s the financial system began suffering serious tremors and in 1979 the Campbell Committee, created by a coalition government under Prime Minister Malcolm Fraser, was established to examine the Australian financial system and to recommend changes.<sup>19</sup> It covered a wide range of issues, reflecting the increased complexities of the financial system and was the first such inquiry since the 1936–37 Royal Commission into Money and Banking, which had imposed very tight regulation, including a prohibition on banks paying interest on cheque account deposits, and laid the ground for a highly anti-competitive Australian banking system.

The Campbell Committee examined the existing structure and operations of the financial system and its recommendations included:

- a more liberal approach to the granting of banking licences, paving the way for building societies to become banks;
- obstacles to major banks competing with building societies for home savings loans business were also removed;

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<sup>17</sup> S J Butlin, *Foundations of the Australian Monetary System 1788–1851* (1968); L F Giblin, *The Growth of a Central Bank — The Development of the Commonwealth Bank of Australia, 1924–1945* (1951).

<sup>18</sup> C B Schedvin, *In Reserve — Central Banking in Australia, 1945–75* (1992).

<sup>19</sup> See Committee of Inquiry into the Australian Financial System (chair: Keith Campbell), *Australian Financial System — Final Report*, AGPS, Canberra, September 1981.

- removal of controls on the interest rates banks could pay and charge, on the terms for which they could lend and the direction of their lending;
- more flexible asset structure for savings banks;
- a freer foreign-exchange market, float of the A\$ and removal of exchange controls; and
- the entry of foreign banks into Australia.

Between 1983 and 1985 the then Treasurer Paul Keating deregulated the system by:

- floating the A\$ in December 1983;
- granting 40 new foreign exchange licences in June 1984;
- granting banking licences to 16 foreign banks in February 1985; and
- adopting most of Campbell's other recommendations.

In the period between 1985 and 1995, following the Campbell inquiry, a number of large, cooperative building societies were converted to companies and then immediately to shareholder (non-mutual) banks. The number of building societies reduced from 178 (in 1970) to 29 (by 1995) and building societies became merged with for-profit banks.<sup>20</sup>

It is evident that following the Campbell inquiry there was a significantly more competitive environment within the banking industry and financial sector as a whole. There were a far greater number of institutions competing for market share than was the case prior to 1981. For example, a number of building societies were allowed to enter the banking market and eventually became regional banks. In New South Wales, the St George Building Society Ltd converted to bank status in 1992. St George Bank went on to merge with various other financial institutions, including in 1996 Advance Bank Australia and the Bank of South Australia (as part of the purchase of Advance Bank). Until last year, St George Bank was one of the most vigorous and successful 'regional bank' competitors to the Big Four banks in Australia.

The Wallis Inquiry,<sup>21</sup> set up under the Howard Government in 1997, recommended, among other things, the abandonment of the Keating Government's 'six pillars' policy, discussed earlier, but the government quickly made it clear that mergers among the Big Four would be prohibited.<sup>22</sup> The inquiry did not oppose a review of proposed acquisitions of Australian banks by foreign banks under the foreign investment and ownership laws, but acknowledged that there would be no particular disadvantage in some increase in the percentage of foreign ownership of the Australian financial system.<sup>23</sup>

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<sup>20</sup> See <[http://www.abacus.org.au/building\\_societies/history.htm](http://www.abacus.org.au/building_societies/history.htm)>.

<sup>21</sup> Financial System Inquiry (chair: Stan Wallis), Final Report, AGPS, Canberra, 1997.

<sup>22</sup> Professor A Fels, *The Wallis Report — Implications for the Insurance Industry*, speech to the Association for Women in Insurance, Victorian Chapter, Melbourne, 14 July 1997.

<sup>23</sup> *Ibid.*

In addition, the inquiry advocated that financial mergers and acquisitions be governed by the same test as other areas; namely, whether the transaction would substantially lessen competition. It also recommended the removal of the blanket prohibition on foreign ownership of the Big Four banks, which was endorsed by the then Federal Government and supported by the ACCC.<sup>24</sup>

The Government and the Wallis Committee observed that foreign investment would bring with it a range of benefits for Australia, including injections of capital, access to new skills and technologies, and enhanced competitive pressure in the banking market. Accordingly, they were prepared to relax the restrictions on foreign ownership. However, the government also expressed the view (shared by Wallis) that any large scale transfer of Australian ownership of the financial system to foreign hands would be contrary to the national interest.<sup>25</sup>

## 45. Bank Mergers in Australia

### i. Key Bank Mergers Pre-1995

In 1981, the Melbourne-based National Bank acquired the Commercial Banking Company of Sydney, while the Bank of New South Wales (later Westpac) acquired the Melbourne-based Commercial Bank of Australia. A decade previously, the Australia and New Zealand (ANZ) Bank had been three separate banks. So, in 1983 when the Hawke-Keating Government came to power, it inherited a market where a mere four banks (the 'Big Four') dominated the Australian banking market.

In 1985, the Australian Government issued 16 licences for foreign-owned bank entry into Australia. The entrants were sizeable entities, but all found entry into retail banking hampered by the expenses of duplicating the extensive branch network that characterises trading bank operations in Australia. This, combined with other factors, meant that by 1990, the Big Four banks still held two-thirds of deposit-taking institutional assets in Australia. The main phenomenon countering the Big Four was the competition that came from the survival of building societies and the conversion of many of those into trading banks.

Until 1995 the Trade Practices Commission (TPC) had not dealt with many bank mergers. Some examples of mergers considered by the TPC in the early 1990s included:<sup>26</sup>

1991: Commonwealth Bank and State Bank of Victoria (which was not found to be a problem under the dominance test and in any case the State Bank of Victoria was a failing firm at the time);

1995: Colonial Mutual Limited (an insurance company) and the State Bank of New South Wales (which was not found to substantially lessen competition as Colonial Mutual Limited was not a bank);

1995: Advance Bank and Bank of South Australia (which was not found to substantially lessen competition as these were two regional banks, operating in two different states);

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<sup>24</sup> *Ibid.*

<sup>25</sup> *Ibid.*

<sup>26</sup> *Ibid* n 22.

1995: Bank of Scotland and BankWest (which was not found to substantially lessen competition as Bank of Scotland was a new entrant in the market).

These mergers did not, at the time, pose any particular problems under the then competition laws and policies; they were assessed under the previous 'dominance' test. A turning point came in how mergers were assessed in 1995, when the 'substantial lessening of competition' test was introduced, and the merger between Westpac and the Challenge Bank was the first bank merger to be assessed under this test (see below).

### **lxxiii. Key Bank Mergers Post-1995**

#### **lxxiv. a. Westpac/Challenge (1995)**

Serious ACCC consideration (or more precisely at the time, TPC consideration) of bank mergers commenced with the Westpac acquisition of Challenge Bank around 1995. Following extensive market inquiries, this merger was found not to be in breach of s 50 of the *Trade Practices Act*. For a start, there was competition from the Big Four banks and also from BankWest, which was seen as a very strong competitor and a sufficient safeguard for competition even if Westpac took over Challenge.

In its media release, the ACCC indicated its general attitude to regional bank mergers throughout Australia. Whilst it would consider bank mergers on a 'case-by-case' basis, the ACCC made it clear it would scrutinise any major trading bank acquisitions of regional banks very carefully. The ACCC went on to say that in any state with only one major regional bank, the ACCC would be especially concerned that such an acquisition would be likely to substantially lessen competition.<sup>27</sup> This would particularly be the case if in any state there was a merger which resulted in the absence from that state of any significant regional bank competitor. This meant that, for example, if there were five banks in a state consisting of the Big Four banks and a major regional bank, then none of the Big Four could take over that regional bank. However, the ACCC qualified this position by saying that each case would be looked at on its merits.

The ACCC's position was reiterated in February 1996, when one of the Big Four, the National Australia Bank (NAB), acquired a 5.8% shareholding in St George Bank. The ACCC made clear at the time that any full acquisition of St George by the NAB would be closely investigated, particularly given St George's position as a regional bank that played a significant role in adding diversity, innovation, closeness to customers and price competition and played a key role in promoting competition and consumer choice in the banking market.<sup>28</sup>

*The 'cluster market' approach* In 1995, the then TPC in the Westpac/Challenge merger defined the market in terms of a cluster of financial services functions.<sup>29</sup> In doing so it

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<sup>27</sup> ACCC media release, MR 017/96, *ACCC 'Case-by-Case' Approach to Banking Mergers*, 29 February 1996.

<sup>28</sup> ACCC media release, MR 014/96, *NAB's Acquisition of 5.8 per cent of St George*, 22 February 1996.

<sup>29</sup> G Samuel, Chairman, ACCC, speech to Australian Bankers Association 3rd Annual Regional Banking and Agribusiness Forum, 9 September 2005; R Jones, Commissioner, ACCC, *Bank Mergers and the Trade Practices Act in the Light of the Westpac/Bank of Melbourne and Commonwealth/Colonial State Bank Mergers*: speech to Melbourne Business School Current Issues Conference (The Dollars and Sense of Bank Consolidation), 12 April 2002.

followed the approach adopted in the United States<sup>30</sup> (which has since changed). That is, instead of looking at banks as offering a vast range of individual products, each of which required separate analysis, the TPC adopted the approach that there was a cluster of banking-type functions (deposits, loans, transactions), and participants were limited to those offering the full range of products and services identified in the cluster. Customers tended to buy a range of, and perhaps all of, their products from one bank and were regarded as having a general relationship with the bank, such that they did not tend to buy one product from one bank and another product from a different bank or financial service provider.

The TPC took the view that there was a competitive advantage in supplying a full range of banking services. In adopting this approach, the TPC noted the importance of regional branch structures and the need for a local branch presence, and came to the conclusion that there was a regional market definition for both retail and small-business banking. It considered that retail customers were unlikely to seek out potential suppliers of banking services interstate in response to a moderate price increase. Similarly, potential interstate suppliers of such services were considered to be unlikely to respond to a moderate price increase in another state.

The TPC also recognised that it was likely that a separate market existed for small business customers who have special banking needs not generally exhibited at retail level; for example, after hours cash deposits, lines of credit and overdraft facilities.

**b. St George/Advance Bank (1996)**

This merger, between two regional banks based in the Sydney metropolitan area, was approved by the ACCC. It fitted the then wider policy of trying to retain the regional banks as a strong force; the ACCC took the view that allowing two regional banks to merge made them a stronger force.<sup>31</sup>

In fact, in its media release, the ACCC said that it considered the merger would strengthen the important second tier of banks and ensure market diversity. The ACCC also considered there was potential for the merger to be pro-competitive, as the merged entity, with strong operations in New South Wales and South Australia, would be able to compete more vigorously with the major banks in these areas. For example, the Advance Bank was very strong in South Australia at the time, so that the merger strengthened further the position of regional banks in that state.

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<sup>30</sup> In the United States, which has a much lengthier experience of regulation of anti-competitive behaviour, cluster markets have arisen for consideration on a number of occasions. Two leading United States cases have established that, in certain circumstances, it may be appropriate to treat a market as consisting of multiple rather than single products. In *United States v Philadelphia National Bank* 374 US 321 (1963) (*Philadelphia National Bank*), the United States Supreme Court considered the appropriate market in which various banking goods and services, such as credit facilities, checking accounts and trust administration services, competed. The court found that, rather than forming distinct markets, those goods and services comprised one unified market for 'commercial banking'. Clustering those products together was justified, the court argued, on the basis that the individual products were not subject to competition because of a 'settled consumer preference' for acquiring them together (see *United States v Philadelphia National Bank* 374 US 321 (1963) at 356–7). In *United States v Grinnell Corporation* 384 US 563 (1966) (*Grinnell*), the US Supreme Court was asked to consider the market in which fire and burglar alarm response services competed. Again, the court found that those services were properly clustered together in a multiple-product market. A cluster market definition was appropriate, the court reasoned, because 'commercial realities' necessitated a supplier supplying those services together (see 384 US 563 (1966) at 572).

<sup>31</sup> ACCC media release, MR 149/96, *ACCC not to oppose St George/Advance Bank Merger*, 25 October 1996.

**c. Westpac/Bank of Melbourne (1997)**

In 1997, the Bank of Melbourne (BML) was the only regional bank in Melbourne. However, the ACCC did not oppose the merger<sup>32</sup> as Westpac was weak in Victoria and, at the same time, other banks were putting significant pressure on the Victorian market. In particular, the St George Bank had entered the Victorian market. In addition, the merger provided the ACCC with the opportunity to obtain significant undertakings (discussed further below) which would have a pro-competitive effect.

By the time of the Westpac/Bank of Melbourne merger in 1997, although the ACCC considered that some product clustering was still occurring, it found that there were a large number of consumers who would shop around from different suppliers to get the best deal. Accordingly, in common with other antitrust authorities, the ACCC moved away from a 'cluster market' approach to an analysis based on looking at individual markets: see below.<sup>33</sup>

*The 'individual market' approach* Following the ACCC's Westpac/Challenge decision, there were significant changes in the banking industry. A highly significant change occurred in the housing loan market with increased competition from mortgage originators. Among other things, this forced banks to reduce sharply their own housing loan interest rates to a point where they largely matched the originators' rates. In turn, these changes put pressure on any subsidies that may have existed from high home-lending rates to fees, charges and other interest rates.

A further consequence was a significant change in customers' attitudes to their relationships with banks. Customer loyalty to banks with whom they did their everyday banking was reduced in regard to housing lending. Further, banks no longer found it so easy to bundle their products. That is, it had become more difficult to sell a cluster or group of products simultaneously where this included a home loan. This influenced the ACCC in moving to a multi-product approach to market definition.<sup>34</sup>

*Undertakings* In addition, Westpac provided the ACCC with strong court enforceable undertakings pursuant to s 87 of the *Trade Practices Act*,<sup>35</sup> in which it effectively opened up the Victorian market to competition from a wider range of financial institutions such as regional banks (including those from other states), building societies, credit unions and any new entrants, by offering Victorian customers of deposit-taking institutions carrying on business in Victoria the use of ATMs (automated teller machines) of the Westpac group (including Challenge and BML) and the use of the EFTPOS system (electronic funds transfer at point-of-sale) at a reasonable price. This gave customers a greater choice of institutions that offered wider electronic access to their accounts both in Victoria and interstate.

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<sup>32</sup> ACCC media release, MR 092/97, *ACCC not to oppose Westpac/Bank of Melbourne Merger*, 25 July 1997.

<sup>33</sup> G Samuel, Chairman, ACCC, speech to Australian Bankers Association 3rd Annual Regional Banking and Agribusiness Forum, 9 September 2005; and R Jones, Commissioner, ACCC, *Bank Mergers and the Trade Practices Act in the light of the Westpac/Bank of Melbourne and Commonwealth/Colonial State Bank Mergers*, speech to Melbourne Business School Current Issues Conference (The Dollars and Sense of Bank Consolidation), 12 April 2002.

<sup>34</sup> Since 1997, some of the individual 'product markets' that the ACCC has looked at in assessing bank mergers have included the following markets: housing; small business; medium to large business; personal loans; credit cards; transaction accounts; wealth management; insurance; and agribusiness.

<sup>35</sup> ACCC media release, MR 092/97, *ACCC not to Oppose Westpac/Bank of Melbourne Merger*, 25 July 1997.

Westpac also undertook that there would be considerable independent BML management of the combined Victorian operations of the merged entity, under the BML brand. The undertakings given provided that, for three years post-merger, BMLs (the merged entity's) Chief Executive Officer would have authority to decide on interest rates, fees and charges in Victoria (except national base/indicator rates, securitised product pricing and national Westpac branded products).<sup>36</sup> The undertakings also provided that a minimum of 100 BML branches (which could include some Westpac branches re-branded as BML) would be opened between 9 am and 12 pm on Saturdays, and for a minimum of eight hours on weekdays.<sup>37</sup>

In addition, BML customers who maintained more than \$400 in their personal current accounts for five out of eight months (starting from 15 May 1997), would be exempt from account keeping and transaction fees in any month in which they maintained at least \$400 in their account, and BML debit card customers would avoid account keeping fees for any month in which they used their debit card at least once.<sup>38</sup>

As a result of such comprehensive undertakings, the ACCC considered that the merger had pro-competitive features that capitalised on the complementary strengths of each bank, such that it was not likely to substantially lessen competition.<sup>39</sup>

**d. Colonial/Tasmanian Trust Bank (1999)**

In 1991, the Tasmanian Trust Bank became the dominant bank in Tasmania when it acquired Tasmania Bank. It was a full service retail bank, providing a range of branch, electronic and mobile banking products to the commercial, rural, housing and personal markets. In 1999, the Tasmanian Trust Bank appeared to be heading for future difficulties from a prudential perspective and was the subject of concern for both the RBA and APRA. Colonial, which at the time had no banking presence in Tasmania, was allowed to acquire the Tasmanian Trust Bank in 1999.<sup>40</sup>

**e. Commonwealth/Colonial (2000)**

Soon after Colonial acquired the Tasmanian Trust Bank, the ACCC was confronted with the proposed merger between the Commonwealth Bank and Colonial State Bank and decided not to oppose it.<sup>41</sup>

The ACCC considered the merger in product markets for:

- large corporate banking;
- retail banking services; and
- non-banking financial services (broadly encompassing retail insurance products, retail investment (funds management) products and wholesale funds management).

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<sup>36</sup> *Ibid.*

<sup>37</sup> *Ibid.*

<sup>38</sup> *Ibid.*

<sup>39</sup> *Ibid.*

<sup>40</sup> ACCC media release, MR 109/00, *ACCC not to Oppose Commonwealth Bank/Colonial Merger*, 30 May 2000.

<sup>41</sup> *Ibid.*

The ACCC did not see the transaction lessening competition in large corporate banking or non-banking financial services. However, the ACCC did have significant concerns in several areas of retail banking where it felt the merger would be likely to result in a substantial lessening of competition in both New South Wales and Tasmania. That said, the ACCC took into account that in New South Wales, St George remained a vigorous competitor in this market, such that this situation fitted in with the ACCC's broad policy approach of protecting competition through the existence of at least one strong regional bank in each state. In relation to Tasmania, the ACCC's market enquiries revealed that the Tasmanian market was not a particularly big market.

*Undertakings* The ACCC took the view that the competition concerns arising from the matter could be addressed by court enforceable undertakings under s 87B of the *Trade Practices Act*. The ACCC agreed to a series of 'quasi-structural' and 'quasi-behavioural' undertakings. However, it pointed out that its decision was not to be seen as providing a precedential direction for how it would deal with future bank mergers.<sup>42</sup>

The ACCC focused on undertakings with two main objectives:<sup>43</sup>

- to make retail banking markets in New South Wales and Tasmania more contestable post-merger (quasi-structural); and
- to minimise the ability of the combined Commonwealth Bank/Colonial entity to exercise market power in New South Wales and Tasmania post-merger (behavioural).

The 'structural' undertakings provided:<sup>44</sup>

- access to Commonwealth Bank EFTPOS and ATM networks on reasonable commercial terms for new and small financial institutions entering or expanding their operations in New South Wales and Tasmania;
- where Commonwealth Bank and Colonial sites in close proximity are to be closed, the Commonwealth Bank agreed to offer those sites to small financial institutions on a fair-value basis for a period of 24 months from completion; and
- for the facilitation of the provision of IT services and credit card debit processing services.

'Behavioural' undertakings were also provided in relation to price, service quality and product range. The Commonwealth Bank agreed to:<sup>45</sup>

- set rates, fees and charges on all products to customers in regional New South Wales and Tasmania so that they were equivalent to or more favourable than the rates, fees and charges imposed on Commonwealth Bank customers in metropolitan New South Wales;

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<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*

- maintain the quality of services to customers in regional New South Wales and Tasmania to an equivalent or more favourable standard than in metropolitan New South Wales; and
- provide to customers in regional New South Wales and Tasmania the same product range, subject to certain conditions, as was available to customers in metropolitan New South Wales.

Although the undertakings were to be in place for a period of five years post-merger, the Commonwealth Bank was released from the undertakings after three years, after the ACCC and the Commonwealth Bank agreed there had been no material breaches of any of its clauses.

**f. Bendigo Bank/Adelaide Bank (2007)**

This merger was not opposed because it involved two regional banks, such that the ACCC concluded that the proposed acquisition was unlikely to substantially lessen competition in any relevant market.<sup>46</sup>

**lxxv. Mergers ‘Present’**

**g. Westpac/St George (2008)**

On 13 August 2008, the ACCC concluded that the proposed acquisition of St George by Westpac was unlikely to substantially lessen competition under s 50 of the *Trade Practices Act* in the markets in which they compete.<sup>47</sup> The ACCC did not consider that there was sufficient evidence to demonstrate that St George had been a uniquely vigorous and effective competitor in any of the retail banking markets, at least to the extent that would be required to show that the removal of St George as an independent player would be likely to lead to a substantial lessening of competition.

The ACCC found that barriers to national entry are high and appear to be even more significant for branch-centric products. The ACCC also found that the level of aggregation that arose from this transaction was relatively limited and that competition in retail banking markets provided by the other major banks and regional banks, along with credit unions, building societies and niche players, would be sufficient to constrain the merged firm after the acquisition.<sup>48</sup>

Clearly, the key point to note with this merger is the abandonment of the policy that there should remain a strong regional bank in each state.

**h. Commonwealth Bank/BankWest and St Andrew’s (2008)**

On 13 October 2008, the Commonwealth Bank of Australia acquired the Bank of Western Australia Limited (BankWest) and St Andrew’s Australia Pty Ltd (St Andrew’s) through the execution of a sale and purchase agreement with United Kingdom-based HBOS plc. On 10

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<sup>46</sup> See <[http://www.adelaidebank.com.au/about\\_adelaide\\_bank/merger.html](http://www.adelaidebank.com.au/about_adelaide_bank/merger.html)>.

<sup>47</sup> ACCC Public Competition Assessment Westpac Banking Corporation proposed acquisition of St George Bank Limited, 13 August 2008.

<sup>48</sup> *Ibid.*

December 2008, the ACCC announced that it would not oppose the acquisition, after concluding that the acquisition was unlikely to substantially lessen competition under s 50 of the *Trade Practices Act*.<sup>49</sup> In his media release,<sup>50</sup> ACCC Chairman, Mr Graeme Samuel, said that prior to the global financial crisis, BankWest, a subsidiary of the United Kingdom bank HBOS, was a keen competitor in the marketplace. However, the ACCC received evidence that BankWest's expansion plans were to be significantly scaled back as a result of the funding difficulties experienced by HBOS, leading the ACCC to form the view that BankWest would be unlikely to continue to act as the aggressive competitor it was previously. The ACCC also examined whether alternative buyers for BankWest would be likely to continue with the bank's expansion strategy and aggressive price competition. The ACCC found that any buyer would need to be in a position not only to raise the purchase price but to repay the approximately \$16 billion in intra-group loans from HBOS.<sup>51</sup>

Following inquiries with financial regulators, HBOS, Australian and overseas banks and other consortia which may have had an interest in acquiring BankWest, the ACCC concluded that an alternative buyer was unlikely in the current funding environment. The ACCC also concluded that, even if another buyer were in a position to acquire the business, it was highly unlikely that they would choose to invest the capital necessary to continue with its expansion plans. APRA and the Reserve Bank of Australia provided information to the ACCC's review that supported the conclusion that BankWest would not continue to be in the same position to provide strong competition going forward.

With BankWest no longer capable of the effective and vigorous competition that it once provided in retail banking markets, the ACCC considered that the acquisition was unlikely to substantially lessen competition compared to the likely future state of competition if the acquisition did not proceed.<sup>52</sup> In agreeing to this acquisition, ACCC Chairman Mr Graeme Samuel was quick to point out that this decision by the ACCC was not to be viewed as a green light to the acquisition of other regional banks by the Big Four banks:

In the absence of the global financial crisis, and the funding difficulties faced by BankWest's overseas parent company, the ACCC's conclusion may well have been different ... The ACCC's views regarding the likely competitive effect of this proposed acquisition are specific to the circumstances of this acquisition. In particular, the financial situation of BankWest's UK parent, and the associated changes it is likely to make to BankWest's operating model in the absence of the transaction, have strongly informed the ACCC's conclusions. The ACCC will closely analyse the competition implications of any further proposed acquisitions of regional banks.

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<sup>49</sup> ACCC media release, MR 347/08, *ACCC not to Oppose Commonwealth Bank of Australia's Proposed Acquisition of Bank of Western Australia Ltd*, 10 December 2008.

<sup>50</sup> *Ibid.*

<sup>51</sup> ACCC Public Competition Assessment Commonwealth Bank of Australia, proposed acquisition of BankWest and St Andrew's Australia, 10 December 2008.

<sup>52</sup> *Ibid.*

## 46. The Way Ahead: Possible Implications of the Global Financial Crisis on Future Bank Mergers

### lxxvi. Background to the Global Financial Crisis — What Happened?

The global financial crisis, initially referred to in the media as a ‘credit crunch’ or ‘credit crisis’, began in mid-2007, when, put simply, a loss of confidence by investors in the value of securitised mortgages in the United States resulted in a liquidity crisis and the collapse of the United States housing market. In September 2008, the crisis deepened as stock markets world-wide crashed and entered a period of high volatility, and a considerable number of banks, mortgage lenders and insurance companies failed in the following weeks.

But, in Australia, Prime Minister Kevin Rudd was quick to state:

The Australian financial system is demonstrating its resilience to the international financial market turbulence. Australia’s banking institutions remain sound, well-capitalised and profitable with high asset quality.<sup>53</sup>

However, it soon became evident that the Australian financial system could not remain immune to global events, and developments in the international wholesale funding markets created acute funding pressures that posed potential risks to the total supply of finance to the Australian economy.<sup>54</sup>

The Australian Government’s response,<sup>55</sup> announced on 12 October 2008, was to:

- guarantee all deposits of Australian banks, building societies and credit unions and Australian subsidiaries of foreign-owned banks, for a period of three years, with no limit on the deposits covered by the government’s Financial Claims Scheme;
- guarantee wholesale term funding of Australian incorporated banks and other authorised deposit-taking institutions (ADIs)<sup>56</sup> to enable Australian institutions to raise funds and to restore confidence in credit markets, in return for a fee in respect of eligible non-deposit debt obligations of eligible institutions; the guarantee is to be withdrawn when market conditions normalise. To ensure taxpayers are not disadvantaged by this guarantee, the government charges financial institutions for providing the guarantee so that in effect the government is insuring the eligible liabilities of Australian financial institutions; and
- direct the Australian Office of Financial Management to purchase an additional \$4 billion in Residential Mortgage Backed Securities (RMBS) from Australian non-ADI lenders (that is, lenders who are not banks, building societies or credit unions), who will not have the benefit of the guarantee of the term funding facility and to ensure that this sector of the lending market has access to funding for its operations.

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<sup>53</sup> Prime Minister of Australia, the Honourable Kevin Rudd, Media Release, *Global Financial Crisis*, 12 October 2008.

<sup>54</sup> *Ibid.*

<sup>55</sup> *Ibid.*

<sup>56</sup> The guarantee on wholesale borrowing is available to Australian-owned banks, Australian subsidiaries of foreign-owned banks, building societies and credit unions. The guarantee is not available to foreign banks, including those with branches in Australia, or entities that are not APRA-authorized deposit-taking institutions.

The Rudd Government's announcement was in direct response to the decision by European Governments (Ireland, Germany, Denmark and Iceland) also moving to insure 100% of eligible deposits. In the United States, the Federal Deposit Insurance Corp voted to approve a bank-debt guarantee program, guaranteeing deposits in non-interest-bearing 'transaction' accounts until the end of 2009.

The unprecedented support provided by governments around the world to their financial institutions in order for them to recapitalise and gain access to wholesale borrowing left the Rudd Government with little alternative but to provide similar guarantees for Australian banks and other financial institutions, to prevent them from becoming uncompetitive in attracting funds in markets that have become increasingly tight and risk-averse as this global financial crisis deepens.

### **Ixxvii. The Guarantees and the Rescue Plans: Competition-Distorting Aid?**

It is clear that the present global financial crisis has seen the virtual decimation of the global financial sector. The huge global imbalances that have necessitated bank rescue packages in Australia and around the world now threaten the viability of banks and as a consequence, competition-threatening bank mergers are likely to become an economic necessity.<sup>57</sup>

In Australia, regional banks were once recognised by the ACCC, the government and the business community as serious challengers to the major banks in the regions in which they operated, and important drivers of innovation in the Australian financial sector. Now, their existence is under threat.

Will the global financial crisis possibly facilitate the acquisition of smaller banks by their larger competitors? Although the Westpac acquisition of the St George Bank preceded Prime Minister Rudd's 12 October 2009 announcement, the impact of the crisis was already being felt. Certainly by the time Commonwealth Bank received approval for its acquisition of BankWest, the government's guarantee had been announced and around the same time, there was much discussion in the media<sup>58</sup> about the fate of Suncorp Metway in Queensland, which has received considerable attention in recent months from the Commonwealth, ANZ and National Australia Banks.<sup>59</sup>

The banks are all facing serious refunding issues as access to overseas funding is threatened. Accordingly, strategic mergers between competitors are likely to increase parties' reliance on the 'failing firm' argument. It is interesting to note that in the Commonwealth

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<sup>57</sup> In the United Kingdom, despite the Office of Fair Trading concluding that the Lloyds TSB takeover of HBOS had a realistic prospect of substantially lessening competition, on 31 October 2008, the Secretary of State cleared the merger without reference to the Competition Commission: see J Vickers, *The Financial Crisis and Competition Policy: Some Economics*, Global Competition Policy Online Magazine, Dec 08 (1) at 8.

<sup>58</sup> 'Commonwealth Tipped to Acquire Suncorp's Bank', *The Australian*, 25 September 2008; 'Now for Suncorp', *Sydney Morning Herald*, 9 October 2008.

<sup>59</sup> If there was a merger between two of the Big Four banks it would almost certainly require consideration by not just the ACCC but also the New Zealand Commerce Commission. The New Zealand test is the same as in Australia: s 47 of the New Zealand Commerce Act 1986 prohibits the acquisition of business assets or shares where that would have the effect or likely effect of substantially lessening competition. The Commerce Commission can grant a clearance under s 66 if it is satisfied that the transaction will not substantially lessen competition. Or it can grant an authorisation under s 67 if public benefits outweigh the detriments from any lessening of competition.

Bank/BankWest merger the ACCC, in its Public Competition Assessment, noted that on 8 October 2008, when the Commonwealth Bank announced its proposal to acquire BankWest and St Andrew's from HBOS, HBOS was experiencing considerable funding pressures despite its announced sale to Lloyds TSB Group plc (Lloyds). HBOS stated that the transaction would result in an immediate and substantial funding benefit. The sale was negotiated in the context of the sharp worsening of global financial markets, when the position of HBOS became increasingly vulnerable in terms of share price and funding.<sup>60</sup>

Despite the role BankWest has previously played in driving retail banking competition, the ACCC received compelling evidence from a range of parties to suggest that BankWest would not be in a position to continue to compete aggressively or act as a price leader.<sup>61</sup> In its Conclusion, the ACCC stated: 'In the absence of the global financial crisis, and the funding difficulties faced by BankWest's parent company, the ACCC's conclusion may have been different'.<sup>62</sup>

Similarly, policy responses<sup>63</sup> since the subprime crisis hit in 2007, including further vast injections of central bank liquidity, extensions of bank deposit guarantees to stave off bank runs by depositors, temporary bans on short selling and sharp cuts in official interest rates, indicate that financial stability has become the primary public interest consideration (although the 'public interest' is not relevant to pure competition issues and is used only as a basis for determining if the authorisation of mergers should be allowed on public benefit grounds).<sup>64</sup>

However, the end result of those policies appears to be that those with stronger balance sheets and cheaper sources of funds (inevitably the larger banks) will be able to better entice consumers with pricing advantages, giving them a better ability to maintain or improve margins and therefore to acquire new businesses. In contrast, as smaller banks and 'lower rated' financial institutions continue to face problems with restricted access to liquidity (and associated costs), they will become less inclined and less able to lend or will do so at very high rates and consumers will have to pay a lot more to borrow.

From a competition law perspective — and in the area of merger control — the concern for the longer term is how to prevent unfair competition among banks and maintain a level playing field in these circumstances, so as to prevent aggressive commercial conduct down the track. For example, where guarantee and recapitalisation plans are not open to all credit institutions and that pricing or the price at which institutions can offer funds will become less attractive to customers, barriers to entry going forward are likely to be very high for new entrants and government intervention will ultimately surely serve to distort competition, which we already know, no matter what the industry, is not in the consumers' best interest.

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<sup>60</sup> ACCC Public Competition Assessment Commonwealth Bank of Australia proposed acquisition of BankWest and St Andrew's Australia, 10 December 2008, p 4.

<sup>61</sup> *Ibid* p 10.

<sup>62</sup> *Ibid* p 15.

<sup>63</sup> J Vickers, *The Financial Crisis and Competition Policy: Some Economics*, Global Competition Policy Online Magazine, Dec 08 (1) at 4.

<sup>64</sup> See *Trade Practices Act 1974* (Cth) s 90(6).

### **lxxviii. What Next?**

‘Rudd Bank’<sup>65</sup> is being set up to protect the commercial property industry from any issues that may be created by a withdrawal of foreign banks. The intention is that the government will contribute \$2 billion to an investment vehicle accessible to owners of commercial property where foreign banks fund part of their asset and those banks withdraw funding. The Big Four banks will also contribute \$2 billion. Notably, the Big Four also compete for the supply of finance to property developers and there have been concerns expressed in the media about the ‘Rudd Bank’ and indeed the government’s overall rescue package being heavily weighted in favour of the Big Four.<sup>66</sup>

If this is the case, the global financial crisis will do more than just bring the banking sector to its knees. It will take us back in time to a situation where we may end up moving from a competitive financial sector to a very concentrated one, where merging parties acquire significant market power, in a bid to help financial institutions withstand the crisis. For Australia, the likelihood is that there will be few, if any, regional or small banks going forward, but four goliaths (or possibly even only three), given speculation that the ANZ and National Australia Banks were apparently also chewing over a merger late last year!<sup>67</sup>

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<sup>65</sup> ‘Swan Defends Rudd Bank’, *The Australian Financial Review*, 29 January 2009, p 46; ‘Rudd’s Bank Fund May Breach Law’, *The Australian*, 29 January 2009, p 4.

<sup>66</sup> ‘Property Bailout Favours Big Four’, *The Australian*, 29 January, 2009, p 4.

<sup>67</sup> ‘ANZ Banks on Becoming No 2’, *The Australian*, 6 May 2006 (online).

# CORPORATE GOVERNANCE DYNAMICS AND TAX COMPLIANCE

Nicola Sartori\*

## Abstract

This article addresses the effects that corporate governance dynamics may have on corporate tax compliance. It critically investigates the interactions between corporate governance and taxation, limiting the analysis to the theoretical effects that corporate governance rules and principles may have on corporate tax behaviours. The purpose of the research is to analyse the connection between corporate governance and strategic tax behaviours, investigating how corporate governance rules can reach a higher level of corporate compliance with the tax system.

The first section offers an overview of the general relationship between corporate governance and taxation; the second section defines corporate governance principles; and the third section investigates possible corporate governance designs that aim to decrease corporate tax compliance and influence corporations' tax attitudes.

The conclusion of the article is that good corporate governance dynamics have a positive impact on tax compliance, discouraging corporations from engaging in aggressive tax planning strategies.

## 47. Introduction

This paper addresses the effects that good corporate governance principles may have on corporate tax compliance. This topic is part of a general research, related to the interactions between corporate governance and taxation.<sup>1</sup>

Since a corporation is a *sui generis* taxpayer, defined by Professor Schon as a 'taxpayer that doesn't exist', it is not clear (i) who bears the corporate tax;<sup>2</sup> (ii) who should be entitled, in the corporate governance context, to comply with tax law; (iii) who should plan the tax strategies; and (iv) who should be responsible for corporate tax obligations.<sup>3</sup> Therefore, the

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\* PhD (tax law), University of Milan, LLM (international taxation), University of Michigan, School of Law; post-doctoral fellow and lecturer in 'Comparative Law and Economics of Taxation', International University College, Turin, Italy; tutor professor of International and Comparative Tax Law, Bocconi University of Milan, Italy; SJD candidate 2009, University of Michigan. I would like to thank Prof Reuven Avi-Yonah for his constant help and wonderful comments. Special thanks to Professors James Hines, Carlo Garbarino and to Dr Ehab Farah for useful comments and revision of the paper. I finally want to thank all the participants of the SJD colloquium at the Michigan University School of Law and the participants of the first CLEF (comparative law, economics and finance) Conference at the International University College of Turin.

<sup>1</sup> For the other part of the research, see N Sartori, *Effects of Strategic Tax Behaviors On Corporate Tax Compliance*, at <<http://www.ssrn.com>> at 2009.

<sup>2</sup> See A J Auerbach, 'Who Bears the Corporate Income Tax: A Review of What We Know' in J M Poterba, *Tax Policy and the Economy* (2006).

<sup>3</sup> W Schon, 'Tax and Corporate Governance: A Legal Approach' in W Schon, *Tax and Corporate Governance* (2008) at 3, emphasises that 'contrary to the situation of the individual taxpayer, the different aspects of tax life are not concentrated in a single person: while a natural person has to pay taxes on his own income and wealth, has to file her own tax declaration and has to pay her own share of taxes, in the corporate context, responsibilities are dispersed, thus leading to opportunistic behavior, principal-agent conflicts, moral hazard and other failures well known from the economic theory of the corporation'.

peculiarity of the corporate governance dynamics for a corporation gives rise to a new challenge, the core of which is the investigation and analysis of how corporate governance rules can be seen as tax enforcement tools.

The interactions between corporate governance and taxation are bilateral and biunique; in fact, on one side, the manner in which corporate governance rules are structured affects the way a corporation fulfils its tax obligations; on the other side, the way tax designs (from the government perspective) and related tax strategies (from the corporation perspective) are planned influences corporate governance dynamics. For example, allowing corporations to keep two different and separate sets of books (one for accounting purposes, the other for tax purposes)<sup>4</sup> makes it easier for tax managers to obtain both tax savings and promising financial statements, even though a critical financial *status* is present. However, the way tax rules are designed may influence the way corporations comply with their substantial and formal tax obligations,<sup>5</sup> as well as the manner in which they structure their ownership and governance dynamics.

This research critically investigates such bilateral relationships limiting the analysis to the theoretical effects that corporate governance rules and principles may have on corporate tax behaviours.<sup>6</sup> Therefore, the purpose of the research is to analyse the connection between corporate governance and strategic tax behaviours, investigating how corporate governance rules can reach a higher level of corporate compliance with the tax system. The research agenda requires (i) to offer an overview of the general relationship between corporate governance and taxation (section 1); (ii) to define corporate governance principles (section 2); (iii) to critically investigate possible corporate governance designs that aim to decrease corporate tax compliance and influence corporations' tax attitudes (section 3); and (iv) to conclude that good corporate governance dynamics have a positive impact on tax compliance discouraging corporations from engaging in aggressive tax planning strategies.

## 48. An Overview of the Use of Tax Law as a Policy Tool for Corporate Governance

The purpose of this section is to give an overview, with reference to the current literature,<sup>7</sup> of the influence of tax laws on corporate governance dynamics.<sup>8</sup>

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<sup>4</sup> See J Anthony, 'Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense' (2003) *Colum Bus L Rev* 35, 37–8, who clarifies that 'in accounting for business transactions in the United States, it has long been the case that keeping two different sets of books (one for financial reporting and one for income tax reporting) is permissible and "generally accepted." A company can often effect a transaction that in economic substance begins at "point A" and ends at "point B," but account for the path taken in one manner in its financial statements and in a markedly different manner in the company's income tax returns'.

<sup>5</sup> On the difference between substantial and formal tax obligation, see F Tesauro, *Istituzioni di Diritto Tributario, Parte Generale* (2006).

<sup>6</sup> The OECD is also giving attention to this linkage between corporate governance and tax. In OECD, 'Final Seoul Declaration' (2006) at 5, has been expressed the objective to expand 'the 2004 Corporate Governance Guidelines to give greater attention to the linkage between tax and good governance'.

<sup>7</sup> The same overview can be seen in N Sartori, *Effects of Strategic Tax Behaviors on Corporate Governance*, at <<http://www.ssm.com>> at 2009. The OECD, in recent studies, provided an institutional framework: *OECD Principles of Corporate Governance* (2004); *Policy Framework for Investments* (2006); *Final Seoul Declaration* (2006). M A Desai and D Dharmapala, 'Taxation and Corporate Governance: An Economic Approach' in W Schon (2008) at 13, provided an

### **Ixxix. The Influence of Tax Law on Corporate Governance Dynamics: Advantages and Disadvantages**

A good corporate governance environment can be achieved by policy makers through direct regulatory action or through tax laws.

Under this heading is a brief analysis of whether tax laws are an efficient policy tool to utilise in order to reach a corporate governance objective. Specifically, this section will address the question whether utilising tax law (that is, tax expenditure or tax penalties) to achieve this objective is preferred over direct regulatory action (that is, subsidies and penalties, or direct expenditures) and to what extent this choice will encourage publicly held corporations to adopt good corporate governance dynamics.

According to the literature, tax law has three different objectives: (i) increasing the revenue for necessary governmental functions; (ii) redistributing wealth among the society and; (iii) influencing specific behaviours.<sup>9</sup> Tax laws may also have unexpected consequences. For example, a tax provision with the mere objective to increase the revenue of a specific country may also indirectly influence the behaviour of certain individuals or entities.<sup>10</sup> Therefore, tax laws can influence corporate governance dynamics directly (that is, as a direct consequence of specific tax policy choices) or indirectly (that is, as an indirect consequence of the way the tax system operates).

Since both tax law and direct regulations can potentially achieve the goal of good corporate governance, the pertinent issue is what tool is preferable in terms of efficiency, equity and simplicity.<sup>11</sup>

economic framework. Finally, W Schon, 'Tax and Corporate Governance: A Legal Approach' in W Schon (2008) at 31 provided a legal framework. All these perspectives will be taken into consideration in this chapter.

<sup>8</sup> The interaction between corporate governance and taxation, as it has been already underlined, is bilateral and biunique. The fact that tax laws may influence corporate governance is also emphasised by the OECD: see *OECD Principles of Corporate Governance* (2004) at 31, according to which 'corporate governance requirements and practices are typically influenced by an array of legal domains, such as (*omissis*) tax law'. See also A Friese, S Link and S Mayer, 'Taxation and Corporate Governance — The State of The Art' in W Schon (2008) at 6, according to whom, first, 'tax systems can influence corporate governance. E.g., taxes can encourage or discourage reorganisations or the payment of dividends to shareholders. They can also affect decisions on whether and how corporate reorganisations and mergers or take-overs take place, in this way having effects on the ongoing governance of corporate groups and on the market for corporate control. Tax obligations and incentives may also have an influence on the way in which companies comply with their obligations of internal and external reporting, especially accounting'. Second, 'rules and mechanisms of corporate governance influence the way in which companies fulfill their tax obligations'.

<sup>9</sup> See R Avi-Yonah, 'The Three Goals of Taxation' (2006) 60 *Tax L Rev* 1, 3, who concludes that taxation has three goals: first, 'taxes are needed to raise revenue for necessary governmental functions, such as the provision of public goods'; second, 'taxation can have a redistributive function, aimed at reducing the unequal distribution of income and wealth that results from the normal operation of a market-based economy'; and third, taxation can also 'be used to steer private sector activity in the directions desired by governments'.

<sup>10</sup> See S S Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' (1970) 83 *Harv L Rev* 706. The author underlines 'a major definitional question: which tax rules are special provisions and therefore tax expenditures, and which tax rules are just tax rules; simply part of the warp and woof of a tax structure?'

<sup>11</sup> See B I Bittker, 'Accounting for Federal "Tax Subsidies" in the National Budget' (1969) 22 *National Tax Journal* 244; S S Surrey, *Harv L Rev*; L Kaplow, 'An Economic Analysis of Legal Transitions' (1985) 99 *Harv L Rev* 509; J R Repetti, 'Accounting and Taxation: The Misuse of Tax Incentives to Align Management-Shareholder Interests' (1997) 19 *Cardozo L Rev* 697; K Hartmann, 'Comment: the Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control through the Federal Tax Code' (1994) 6 *DePaul Bus LJ*.

### **lxxx. The Use of Tax Laws as a Regulatory Tool for Corporate Governance**

The existing literature has underlined two main advantages in using tax rules rather than direct regulations for encouraging publicly-held corporations to have good corporate governance dynamics.

First, a simplicity argument can be raised in favour of tax laws over direct regulations. The use of tax laws instead of direct regulations allows the government to rely on an existing and established system (the tax system). The costs incurred by governments to slightly modify an existing and established system would be lower than the costs needed to create, manage and administer a new system (that is, the regulatory system). In other words, the administrative costs incurred by governments would be higher for putting in place a new regulatory system compared with the alternative of utilising an existing tax system. Moreover, the fact that governments can rely on a well-know system is likely to increase the effectiveness of the process, since the impact of tax rules on corporate governance dynamics would probably be faster than that of direct regulations. New direct regulations would require governments to create a new system for the implementation and supervision of those regulations,<sup>12</sup> increasing administrative costs and delaying the impact on corporate governance.

Some authors also believe that the time and resources expended by taxpayers to interact with the tax system would be less than the time and resources that would be spent to comply with a new regulatory system. In other words, compliance costs would be less using pre-existing tax laws, since tax provisions are considered less complicated than other provisions because they are already established and thus known.<sup>13</sup>

Second, the use of the tax system rather than a regulatory system would promote the private decision-making process of individuals. In fact, while the use of tax laws (and more specifically of tax expenditures) gives a choice to taxpayers whether to comply with the policy request of the government or not, direct regulations would not leave such choice to taxpayers, but to the government, favouring a government-centred decision-making process. This argument has been raised by the literature in the contest of using tax laws or direct regulations in solving social problems.<sup>14</sup> In the author's opinion, it is not clear whether the same argument can be raised with reference to corporate governance. Moreover, it seems that the argument is weak because, depending on how the regulations and penalties are structured, a tax system may favour a government-centred decision-making process, while a regulatory system may well favour a private decision-making process.<sup>15</sup>

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<sup>12</sup> See S S Surrey, *Harv L Rev* 717. *Contra*, K Hartmann, *DePaul Bus L J*, according to whom: 'It is not the mere use of the tax system that makes a particular provision simple, rather, it is a substantive decision to have a simple program. While it is true that direct programs are often over structured and inefficient, the answer does not necessarily lie in using the tax system, but in designing a simple system for administering a direct plan. Furthermore, the greater simplicity often found in tax code provisions, as opposed to direct programs, may merely reflect a lack of scrutiny and foresight in planning the tax provisions'.

<sup>13</sup> See S S Surrey, *Harv L Rev*; and A Friese, S Link and S Mayer, 'Taxation and Corporate Governance — The State of the Art' in W Schon (2008).

<sup>14</sup> See S S Surrey, *Harv L Rev* 718.

<sup>15</sup> A Friese, S Link and S Mayer, 'Taxation and Corporate Governance — The State of the Art' in W Schon (2008) at 394. The authors underline how 'as long as a direct fine is compared with an indirect tax penalty it seems very unlikely that there is any difference for the affected individual because the after-tax costs of the regulatory measure are equal in both cases. If the regulated conduct was prohibited instead, a tax would obviously be more flexible'.

### **lxxxi. The Use of Direct Regulations as a Regulatory Tool for Corporate Governance**

Three main arguments can be raised in favour of direct regulations rather than tax laws as policy tools for encouraging publicly-held corporations to adopt good corporate governance dynamics. These three arguments are based on the interaction between the economic principles of taxation (that is, equity and efficiency) and the agency framework.

First of all, an equity argument can be made. A principle of horizontal equity prescribes that ‘individuals’ at the same level of wellbeing should have the same tax burden,<sup>16</sup> while a principle of vertical equity prescribes that the government should be actively involved in income redistribution among ‘individuals’ according to a trade-off between equity and efficiency based on a the ‘ability to pay’ principle.<sup>17</sup> Since *tout court* tax incentives or tax penalties would have a stronger impact on taxpayers with a high taxable income rather than taxpayers with a low taxable income or with losses, and tax incentives and tax penalties are regressive measures,<sup>18</sup> the use of tax laws, for purposes that are different from mere redistribution or the increase of the government’s revenue, has an impact on the equity issues *supra* mentioned. For example, a taxpayer with zero tax liability would not be affected by a provision prescribing, as a tax penalty, the non-deductibility of certain expenses. Nevertheless, it is the author’s opinion that this argument is weak for at least two reasons: (i) as already mentioned, corporations are *sui generis* taxpayers to whom it is doubtful that equity principles should apply;<sup>19</sup> and (ii) not every tax expenditure is more regressive than a direct expenditure; this depends on how the tax expenditures are structured compared with direct expenditures.<sup>20</sup>

Second, an efficiency argument could also be raised. The use of tax law rather than direct regulations would seem inefficient because it creates a distortion in the allocation of resources and therefore in the behavioural responses to tax law. Nevertheless, in the author’s opinion, this criticism is weak for at least two reasons: (i) direct regulations may also create a distortion in the allocation of the resources; and (ii) the use of tax law as a policy tool is not inefficient when there is an overall increase of positive externalities.<sup>21</sup>

The third and most important criticism of the use of tax expenditures in the corporate governance context relates to the endemic conflict between managers and shareholders that characterises publicly-held corporations. In fact, corporate managers may not be efficiently reactive to tax incentives or tax penalties imposed on corporations, since they are not the direct addressees of these measures. Based on a cost/benefit analysis managers may well

<sup>16</sup> In general, on the principle of horizontal equity, see J Slemrod and J Bakija, *Taxing Ourselves: A Citizen’s Guide to the Debate over Taxes* (2004) 85 ff.

<sup>17</sup> In general, on the principle of vertical equity see *ibid* at 57 ff.

<sup>18</sup> See K Hartmann, *DePaul Bus L J* 194. According to the author: ‘This regressivity is a function of two factors. First, individuals with income under taxable levels do not benefit from a deduction. Secondly, because less wealthy individuals are taxed at lower marginal rates, tax deductions are marginally less beneficial to them’.

<sup>19</sup> Since, economically, corporations do not pay taxes because people end up bearing the burden of tax, it is doubtful that the equity principles should apply to corporations.

<sup>20</sup> In fact, we may have both a direct expenditure related to income (which would then be regressive) and a tax expenditure non related to a progressive income tax (therefore, not regressive).

<sup>21</sup> See J Slemrod and J Bakija (2004) 122. The authors clarify that ‘when the difficulty of obtaining necessary information, the presence of activities with spill over effects, or monopoly leads markets to function inefficiently — when the invisible hand fails — taxes do not necessarily detract from efficiency. On the contrary, they may correct an inefficiency’.

prefer bad corporate governance dynamics, which may allow them to opportunistically increase their interests, instead of a tax benefit, or instead of incurring a tax penalty. On the contrary, following this argument, a regulatory system may easily take into account the agency framework in which managers operate. Therefore, using tax incentives or tax penalties the government may waste more resources in order to obtain the same objective. However, in the author's opinion, this last argument is weak because it is based on wrong assumptions. First, this argument is based on the assumption that managers do not bear the corporate tax.<sup>22</sup> This appears to be wrong since managers, in the short term, indirectly bear the corporate tax, because it reduces their powers. The above argument is based on a second wrong assumption, which is the fact that the tax measures cannot be addressed directly to managers. Professor Slemrod clarifies that penalties imposed on corporate tax managers are more effective in reducing evasion than are those imposed on shareholders.<sup>23</sup> Therefore, even in the contest of encouraging certain corporate behaviours, tax incentives or tax penalties imposed on managers may be more effective than if imposed on the corporations or the shareholders.

## 49. The OECD Principles of Good Corporate Governance

### lxxxii. Principles of Good Corporate Governance

The concept of good corporate governance adopted in this paper is the one given by a report of the OECD in 2004.<sup>24</sup> Every jurisdiction should impose or encourage publicly-held corporations to follow good corporate governance.

Even though a single ideal model of appropriate corporate governance does not exist, in 2004 the OECD developed, in conjunction with national governments, this set of corporate governance standards and guidelines (that is, 'good' corporate governance principles), with the purpose to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.<sup>25</sup>

The good corporate governance principles can be summarised as follows. The corporate governance framework should:

- (1) promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities;
- (2) protect and facilitate the exercise of shareholders' rights;

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<sup>22</sup> In general, on the incidence of corporate taxes see A J Auerbach, 'Who Bears the Corporate Income Tax: A Review of What We Know' in J M Poterba (2006).

<sup>23</sup> K J Crocker and J Slemrod, 'Corporate Tax Evasion with Agency Costs' (2005) 89 *Journal of Public Economics* 1593 at 1.

<sup>24</sup> OECD, *OECD Principles of Corporate Governance* (2004).

<sup>25</sup> *Ibid* at 11.

- (3) ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights;
- (4) recognise the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises;
- (5) ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company;
- (6) ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.<sup>26</sup>

For the purposes of this paper, it will be assumed that governance dynamics and rules are appropriate if they meet the above standards and guidelines.

### **lxxxiii. Good Corporate Governance Principles and the Economy**

After identifying what good corporate governance is, the research requires to briefly investigate the reasons why,<sup>27</sup> both developed and non-developed jurisdictions should impose (or at least encourage) publicly-held corporations to adopt a good corporate governance environment. The author believes that good corporate governance principles may have at least two positive effects on the economy: first, they would provide the right incentives for managers to refrain from behaving opportunistically, but rather in the interest of the company (*recte*, the shareholders); second, they would augment the proper functioning of a free market economy.<sup>28</sup> In this regard, the OECD has underlined that 'as companies play a pivotal role in our economies and we rely increasingly on private sector institutions to manage personal savings and secure retirement incomes, good corporate governance is important to broad and growing segments of the population'.<sup>29</sup> In other words, good corporate governance is key to the integrity of corporations, financial institutions and markets, and central to the health of our economies and their stability; therefore, policy makers should promote good principles of corporate governance.<sup>30</sup>

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<sup>26</sup> See *Ibid.*

<sup>27</sup> However, the primary objective of this research is not to emphasise the importance of good corporate governance, but how to reach such a goal.

<sup>28</sup> This is because good corporate governance lowers the cost of capital and encourages a more efficient use of resources. See OECD, *OECD Principles of Corporate Governance* (2004) 13. In fact, according to the OECD, 'good corporate governance practices will help improve the confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing'.

<sup>29</sup> *Ibid* at 3.

<sup>30</sup> See <[http://www.OECD.org/document/48/0,3343,en\\_2649\\_34813\\_42192368\\_1\\_1\\_1\\_37439,00.html](http://www.OECD.org/document/48/0,3343,en_2649_34813_42192368_1_1_1_37439,00.html)>.

## 50. Policy Responses to Strategic Tax Behaviours: Corporate Governance as a Possible Tool

### lxxxiv. Introduction

In this chapter is an analysis of the extent to which corporate governance tools can be used to reach a higher level of corporate tax compliance, with the conclusion that good corporate governance dynamics, according to the OECD principles of corporate governance, have a positive impact on tax compliance.

The OECD has clarified that good corporate governance should ‘recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises’.<sup>31</sup> In order to create wealth and jobs it seems essential that managers have an incentive to make sure that corporations comply with tax law and pay their fair amount of taxes. The importance of corporate governance tools in deterring non-compliance behaviours has been clearly emphasised by the OECD countries in the Final Seoul Declaration: ‘Our discussions revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements’.<sup>32</sup>

Good corporate governance would give stakeholders a right to freely communicate their concerns both about illegal behaviours (like tax evasion) or unethical behaviours (like tax avoidance), since such behaviours would have a negative impact on the reputation of a firm as a whole and increase the future risk of (tax) liabilities and (tax) penalties.<sup>33</sup>

Therefore, as an example of a developed jurisdiction, the United States has adopted many policy responses in response to tax shelters in the context of corporate governance: 1) new disclosure rules have been adopted in order to give information faster to the IRS; 2) enactment of the Sarbanes and Oxley Act. This Act includes responsibility clauses against managers; 3) M-3 section has been added to corporate tax returns. This section is aimed at conciliating book results with tax results within the tax return; 4) FIN 48 rules have been enacted in order to reveal to the public any risk of tax burdens due to failed tax planning.

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<sup>31</sup> See OECD, *OECD Principles of Corporate Governance*, Paris (2004) 21.

<sup>32</sup> OECD, *Final Seoul Declaration* (2006) 3.

<sup>33</sup> See OECD, *OECD Principles of Corporate Governance* (2004) 47, which clarifies: ‘[S]takeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this. Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company and its shareholders in terms of reputation effects and an increasing risk of future financial liabilities. It is therefore to the advantage of the company and its shareholders to establish procedures and safe-harbours for complaints by employees, either personally or through their representative bodies, and others outside the company, concerning illegal and unethical behaviour. In many countries the board is being encouraged by laws and or principles to protect these individuals and representative bodies and to give them confidential direct access to someone independent on the board, often a member of an audit or an ethics committee’.

### **lxxxv. Transparency, Alignment of Shareholders and Managers Interests and Corporate Tax Compliance**

It seems clear that not only tax laws can influence corporate governance dynamics, but also corporate governance dynamics can have an effect on taxation, influencing corporate tax behaviours. This section provides an overview of why corporate governance rules can affect the way a corporation fulfils its formal and substantial tax obligations.

The OECD countries all agree that once national tax laws have been enacted, they need to be enforced.<sup>34</sup> One of the ways to enforce tax law rules (that is, to increase corporate tax compliance) is to use corporate governance tools. Forcing corporations to adopt certain corporate governance dynamics has an impact on corporate tax behaviours.

As a matter of fact, the objectives of corporate tax managers in the United States, as well as in other developed jurisdictions, have changed from passive compliance to aggressive tax planning (most often illegal, but certainly illicit because against the spirit of the law).

In this paper is argued that managers of publicly-held corporations that adopt good corporate governance principles comply with the tax system and are not encouraged to evade, or elude, the payment of corporate taxes.

However, if the relationship between shareholders and managers is conducted within a principal-agent framework,<sup>35</sup> one may think that if managers are encouraged to follow shareholders' interests they will probably act in order to reduce the tax burden and maximise the after-tax profit. On the other hand, if managers are not encouraged to follow shareholders' interests, they will most likely behave opportunistically maximising their own interests. Therefore, if the corporate governance rules do not encourage managers to behave for the shareholders' interest (that is, if there is diversion) managers may be tempted to report to the market higher income, even if this causes higher income to be reported on the tax return (and consequently higher taxes), because this will inevitably cause an increase of the value of the corporations making it more prestigious.

This argument is only partially true, because it wrongfully assumes that shareholders want managers to minimise the corporate tax burden. On the contrary, public shareholders do not want managers to minimise corporate tax obligations, but they prefer to invest in corporations paying their fair amount of corporate taxes. Indeed, there are three reasons why public shareholders may not want managers to engage in strategic tax planning:

- (1) In order to reduce risks of legal challenges and penalties, any transaction that does not have a real business purpose and is designed solely to avoid taxes has to be mischaracterised and obscured by managers. These opaque transactions make it harder for outside investors (current and future shareholders and bondholders) to control insiders (managers). Utilising opaque transactions, smart tax managers may easily behave opportunistically, maximising their profits and causing extra costs unseen by the shareholders. As a result, corporate governance rules that do not guarantee strong transparency can benefit the private interests of managers to the

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<sup>34</sup> See OECD, *Final Seoul Declaration* (2006) 3.

<sup>35</sup> *Contra*, J R Graham and A L Tucker, 'Tax Shelter and Corporate Debt Policy' (2006) 81 *Journal of Financial Economics* 563, who believe that corporate tax shelters are merely tax-saving devices without any other agency dimensions.

detriment of shareholders. The *vice versa* is also true: under good corporate governance rules which grant transparency, it is more difficult to shelter taxable income. Thus, better corporate governance can reduce tax avoidance.

- (2) The interest of investors in corporate social responsibility has increased sharply in recent years. Public investors seem to be interested in ethical behaviours of corporations. Therefore, good corporate governance which grants alignment of interests and transparency prevents managers from engaging in strategic tax behaviours.
- (3) The third reason is related to a recent finding of the literature. Professor Slemrod has suggested that corporations should always behave as if they are risk-neutral, even if shareholders are not, because shareholders have already diversified the risk by holding diversified portfolios based on the assumption that corporations are risk-neutral.<sup>36</sup>

In conclusion, an alignment of interests, given by good corporate governance principles, would induce managers to behave as risk-neutral persons managing the corporation's business and not encourage managers to minimise corporate taxes.

Therefore, since shareholders seem to prefer to invest in corporations that do not engage in aggressive tax planning, an alignment of interests would cause managers not to engage in strategic tax strategies. Moreover, as has been shown in another paper,<sup>37</sup> corporate tax strategies aimed at pure tax minimisation (in particular through tax sheltering) generate direct implementation costs and exposure to risk of tax sanctions/regulatory control, so that managers typically ensure that these actions are obscured from tax authorities, thereby pursuing self-serving objectives and creating additional costs.

Moreover, one of the main principles suggested by the OECD to policy makers for good corporate governance is based on disclosure and transparency. In fact, 'the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company'.<sup>38</sup> Through a high level of transparency, managers (or insiders in general) cannot divert income and cannot increase their interests to shareholders' detriment.

#### **lxxxvi. Personal Responsibility of Managers**

The OECD underlines that an 'important board responsibility is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws'.<sup>39</sup> Therefore, in the corporate governance context, tax compliance seems to be part of the managers' responsibilities.

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<sup>36</sup> J Slemrod, 'The Economics of Corporate Tax Selfishness' (2004) 57 *National Tax Journal* 882.

<sup>37</sup> See N Sartori at <<http://www.ssrn.com>> at 2009.

<sup>38</sup> See OECD, *OECD Principles of Corporate Governance* (2004) 22.

<sup>39</sup> See *Ibid.*

Moreover, the OECD countries, in the Final Seoul Declaration, have identified the personal responsibility of managers as a possible tool to defeat aggressive tax planning.<sup>40</sup> Nevertheless, as a matter of principle, such personal responsibility does not seem to be generally accepted in the OECD countries, and especially in European Countries. In fact, as correctly underlined by Professor Schon: ‘[I]f tax law wants to introduce any additional individual obligations of directors, shareholders or other persons in the context of corporate taxation they have to be laid down specifically by the legislator’. This is also true in the United Kingdom-United States context, where ‘the generally accepted rule that the management is responsible for tax compliance — bookkeeping, declarations, tax returns, tax audits, tax payments — does not automatically transform these duties into personal obligations towards the tax inspector. If tax authorities want to enforce corporate tax claims against the directors and officers of the company they have to rely on further reaching mechanisms’.<sup>41</sup>

In the United States tax legislation § 6672 of the Internal Revenue Code comes to mind. Dealing with personal responsibility, this section prescribes a 100% penalty for non-payment of taxes withheld from employees’ pay. Persons held responsible are those identified as any ‘person required to collect, truthfully account for and pay over any tax imposed’, like, for example, a director of a corporation.<sup>42</sup>

### **lxxxvii. Public Disclosure of Corporate Tax Return Information**

One of the possible corporate governance tools that may have an impact on tax compliance is the tax/book income reconciliation. As is commonly known, the main objective of managers and corporations in general is to increase the book income, while, at the same time, keeping taxable income as low as possible (based on an effective tax planning strategy). There are at least three possible reforms that may motivate managers to comply with the tax system within this context.

#### **ff. Publication of the Whole Tax Return**

One possibility is to exploit the incentive of managers to increase book income by enforcing the publication of tax returns; this would most likely reduce the incentive of tax managers to engage in aggressive tax planning strategies because a high gap between tax and book income

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<sup>40</sup> See OECD, *Final Seoul Declaration* (2006) 3, 4. Specifically, six possible policy responses to noncompliance have been underlined: ‘Employing effective risk management techniques at the organisational and operational levels and sharing our assessments of risk with taxpayers; Strengthening the enforcement process, taking appropriate civil and criminal actions for noncompliance and putting more resources into international cooperation; Exploring the need for dedicated organisational units to deal with offshore non-compliance; Addressing the role of accounting and legal firms, investment banks and other institutions in promoting the use of tax shelters to non-comply with the tax rules; Encouraging top management and audit committees of large enterprises (for example, CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies; Developing a whole of government approach to dealing with the problems posed to law enforcement agencies in today’s more open and global environment’.

<sup>41</sup> See W Schon, ‘Tax and Corporate Governance: A Legal Approach’ in W Schon (2008). The author emphasises the fact that as a general principle, the ‘obligation of directors to administrate the tax affair of the company are part of the duties they owe in the context of a principal-agent relationship to the company and the shareholders, not towards the government’. Personal responsibility can be found within the context of insolvency law, but in this paragraph we are trying to identify the reasons for having a personal responsibility of managers within the framework of tax law.

<sup>42</sup> See, for a comment on this disposition, C E Watson, *Tax Procedure and Tax Fraud in A Nutshell* (2005) 228 ff.

would be perceived by the market as a signal of possible misleading of profits from the corporation to the public. However, it is not clear whether shareholders would prefer high tax income or low tax income.

Professors Lenter, Slemrod and Shackelford discuss the pros and cons of this proposal, concluding that the disclosure of the entire corporate tax return could cause companies to dilute the information content of these returns, hampering tax enforcement, and may reveal proprietary information that could provide a competitive advantage to those companies that are not required to make such a disclosure.<sup>43</sup> Nevertheless, the OECD suggests that good corporate governance requires companies to disclose information that may endanger their competitive position if such information is necessary to fully inform the investment decision and to avoid misleading the investor.<sup>44</sup>

#### **gg. Single Concept of Income for Both Book and Tax Purposes**

A second proposal is to force corporations to adopt a single definition of income both for tax purposes and for book purposes. In other words, corporate taxable income would be equal to financial statement income. Such reform would certainly restrain overstatement of earnings and restrain understatement of taxable income. However, it would probably erode the information value of earnings, as the political process uses the tax system for economic and political purposes. As explained above, the current tax shelters activity permits tax managers to decrease taxable income while at the same time increase financial income.

#### **hh. Publication of the Bottom Line of the Tax Return**

A third proposal is to publish only the bottom line of the tax return. This would contribute to the transparency of the tax system and therefore would have three main advantages. It would put pressure on the policy makers to improve the tax system; induce corporations to resist aggressive tax planning if they fear that low tax burdens would have a negative impact on consumers; and contribute to better functioning of financial markets if it sheds new light on the information reported.<sup>45</sup>

However, on the other hand, the low tax reported by corporations could be seen as a benchmark to other corporations that would then try to reach the same level of low taxes.

#### **lxxxviii. Different Compensations to Managers**

Aligning key executive and board remuneration with the longer-term interests of the company and its shareholders is a requisite of good corporate governance.<sup>46</sup>

In all developed jurisdictions it is possible to find within the borders of the law, both a duty of loyalty and a duty of care. A duty of loyalty is a doctrine that forbids ‘directors, officers

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<sup>43</sup> D Lenter, J Slemrod and D Shackelford, ‘Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives’ (2003) 56 *National Tax Journal* 803.

<sup>44</sup> See OECD, *OECD Principles of Corporate Governance* (2004) 50: companies are not ‘expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor’.

<sup>45</sup> *Ibid.*

<sup>46</sup> See OECD, *OECD Principles of Corporate Governance* (2004).

and auditors from entering unfair or illicit self-dealing transactions or otherwise misappropriating company assets'.<sup>47</sup> A duty of care is a doctrine that 'requires board members to act on a fully informed basis, in good faith, with due diligence and care'.<sup>48</sup>

For example, Professors Crocker and Slemrod, within a costly state falsification framework, characterise the optimal incentive compensation contract and how such a contract changes in response to alternative enforcement policies imposed by the tax authorities. They conclude that penalties imposed on tax managers are more effective in reducing evasion than those imposed on shareholders.<sup>49</sup>

Professors Desai and Dharmapala found that increases in incentive compensation tend to reduce the level of tax sheltering, in a manner consistent with a complementary relationship between diversion and sheltering. In addition, they found evidence suggesting that this negative effect is driven primarily by firms with relatively weak governance arrangements. These results may help explain the growing cross-sectional variation among firms in their levels of tax avoidance, the 'undersheltering puzzle', and why large book-tax gaps are associated with subsequent negative abnormal returns.<sup>50</sup> The author concludes that technological complementarities between sheltering and diversion make tax avoidance less likely when managerial interests are more closely aligned with shareholder interests.<sup>51</sup>

## 51. Conclusions

The conclusion of this paper is that good corporate governance has a positive impact on corporate tax compliance.

One could argue that good corporate governance would result in strong alignment of interests of shareholders and managers and therefore managers would behave in the interest of the shareholders, minimising the corporate tax burden through the use of aggressive tax planning strategies. As it has been already explained, this argument is weak for at least three reasons. First, recent studies regarding corporate social responsibility have shown that public shareholders view corporate tax obligations as a corporate social responsibility and, therefore, they do not want managers to engage in aggressive tax planning. Second, good corporate governance results in a high level of transparency and such transparency would indirectly prevent managers from engaging in strategic tax behaviours.<sup>52</sup> Third, since shareholders diversify the risk, holding diversified portfolios based on the assumption that corporations are

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<sup>47</sup> This definition is given by R H Kraakman, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) 114–15.

<sup>48</sup> This definition is given by OECD, *OECD Principles of Corporate Governance* (2004) 59. *Contra*, W Schon, 'Tax and Corporate Governance: a Legal Approach' in W Schon (2008), according to whom '[t]he duty of care requires the management to take all decisions which are expected to bring about a positive net return on investment'.

<sup>49</sup> See K J Crocker and J Slemrod, *Journal of Public Economics*.

<sup>50</sup> See M A Desai and D Dharmapala, 'Taxation and Corporate Governance: An Economic Approach' in W Schon (2008).

<sup>51</sup> See M A Desai and D Dharmapala, *Earnings Management and Corporate Tax Shelters* (2006) SSRN.

<sup>52</sup> In fact, M A Desai and D Dharmapala, 'Corporate Tax Avoidance and High Powered Incentives' (2006) 79 *Journal of Financial Economics* 145, 148, underline that 'the simple intuition that increased alignment of shareholder and manager interests would lead to greater tax sheltering activity is theoretically only a special case, and empirically not operative. While the underlying rationale for our interpretation (that sheltering and diversion are complementary) could appear counterintuitive, it is consistent with a growing body of legal and anecdotal evidence'.

risk-neutral,<sup>53</sup> corporations should always behave as if they are risk-neutral and an alignment of interests, given by good corporate governance principles, would induce managers to behave as risk-neutral persons managing the corporation's business.

In conclusion, an alignment of interests and a higher level of transparency, given by good corporate governance principles, induce managers to comply with the tax system, without minimising corporate tax obligations with aggressive tax planning strategies.

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<sup>53</sup> J Slemrod, 'The Economics of Corporate Tax Selfishness' (2004) 57 *National Tax Journal* 882.

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# Comments



# THE DOMESTICATION OF THE UNCITRAL MODEL LAW IN AUSTRALIA

Nicola Nygh and Sam Luttrell\*

## 52. Introduction

On 17 April 2009, the Standing Committee of Attorneys-General (SCAG) announced that the ‘uniform’ state *Commercial Arbitration Acts* (1984–5) (*CAAs*) of the Australian states will be replaced by new statutes based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration (the Model Law). With Model Law State Arbitration Acts, local users of arbitration will have more freedom to agree on the procedures they will use to resolve their dispute. If the parties make the right choices, their dispute will be resolved faster and with less expense than it would have been had they gone to court. Supporting the parties’ broad autonomy, state courts will have less power to intervene in arbitration. After the close of proceedings, the grounds upon which the arbitral award may be set aside will be more limited than they are under the current system. The purpose of this chapter is to introduce the Model Law, briefly compare it to the current state Acts, and consider some of the possible adaptations that will be made to the UNCITRAL template when it is introduced in the states.

## 53. The Current System

Australia has two streams of arbitration law at present: one set of state laws for domestic disputes, and a federal law for international matters. Domestic arbitrations are governed by the *CAAs* while disputes of an international nature fall under the *International Arbitration Act 1974* (Cth) (the *IAA*). The Australian *lex arbitri* is, therefore, ‘dualist’. But because the domestic arbitration laws of the states are ‘uniform’ (or at least very similar — they are not identical), Australian dualism is relatively simple. At the other end of the scale are countries with complex dualism. A good example is the United States, where domestic arbitration laws vary greatly state-to-state and often clash with the single, antiquated federal statute that governs international disputes.

In Australia, dualism is significant in practice because the question of which system of law governs the arbitration determines the procedural freedom of the parties and the finality of the award. The state and federal systems are quite different. While the *IAA* is based on the Model Law, the *CAAs* are not (although in some areas state jurisprudence has been influenced by the Model Law — bias challenges are an example). The *CAAs* give the parties much more scope to apply to the courts for judicial supervision of an arbitration and for the setting aside of arbitral awards than the *IAA*. Sophisticated users of arbitration tend to prefer the freedom of the Model Law, but their ability to adopt the Model Law provisions is limited where the dispute is not international. If the states adopt laws based on the Model Law, the procedural law applicable to domestic arbitration will be very similar to that applicable to international

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\* Nicola Nygh is Special Counsel in the Litigation & Intellectual Property practice group at Allens Arthur Robinson in Sydney. Dr Sam Luttrell is a lawyer in the Projects practice group at Allens Arthur Robinson in Perth.

arbitration. This will make Australia more like England and Switzerland, where there are single arbitration statutes covering both domestic and international disputes.

When a country has one body of arbitration law for domestic and international matters, arbitration lawyers call it a 'monist' jurisdiction. If the states adopt the Model Law outright (which would be ideal), Australia will become monist. Although scholars and practitioners are divided on the merits of monism and dualism, in international arbitration lawmaking the current trend is probably slightly in favour of monism. This is because monism compliments the broad policy objective of harmonising arbitration law. At the forefront of the harmonisation movement is the Model Law.

## 54. The UNCITRAL Model Law

The Model Law is a template national law that was drafted in consultation with UNCITRAL member states. Unlike the New York Convention on the Enforcement and Recognition of Foreign Arbitral Awards (1958), the Model Law is not a treaty. However, one of the main objectives of the UNCITRAL Working Party that drafted the Model Law was to support the New York Convention enforcement framework by harmonising national arbitration laws. Nearly 50 countries, including almost all of the common law states of the Asia-Pacific region (except for Brunei), have adopted the Model Law.

The first version of the Model Law was settled in 1985, and the template was revised in 2006. The most important 2006 amendments were those directed at modernising the Model Law form requirements for a valid arbitration agreement. The *IAA* implements the 1985 version of the Model Law, but the Federal Government is currently considering whether, and to what extent, the *IAA* should be amended to adopt the 2006 amendments to the Model Law. The Commonwealth Attorney-General invited submissions on this and other questions last year, and the consultation process is continuing.

The Model Law gives users of arbitration broad freedom to tailor the arbitral procedure to their needs. It also provides that local courts can only set aside arbitral awards where:

- there was no agreement to arbitrate or the dispute falls outside the scope of the arbitration agreement (Art 34(2)(a)(i));
- there was an actionable breach of procedural fairness in the making of the award (Art 34(2)(a)(ii), (iv));
- the subject matter of the dispute was not capable of settlement by arbitration (Art 34(2)(b)(i)); or
- enforcement of the award would be against 'public policy' (34(2)(b)(ii)).

Otherwise, the parties are bound by the decision of the arbitrators.

In contrast, the *CAAs* provide exhaustive grounds upon which judicial review of the award may be sought, including that the award contains a 'manifest error of law' (*CAA* s 39(5)). Much ink has been spilt criticising this rule, and many hours have been spent arguing for and against its application in state courts. There is a good argument that it has been bad for arbitration. With 'manifest error of law' hanging over their heads like a Sword of Damocles, the willingness of the arbitrator to conduct the dispute efficiently and flexibly is, to some

extent, off-set by his or her fear that their award will be set aside. Manifest error of law has also reduced the involvement of non-legally qualified arbitrators, with the result that the opportunity to have a dispute resolved by a technical expert is often lost. Anecdotal experience suggests that engineers, architects and quantity surveyors have been scared off by the ‘manifest error of law’ rule.

The way in which Australian courts have interpreted the *CAAs* also tends to encourage arbitrators to conduct domestic arbitrations like court proceedings. For example, in *Oil Basins Limited v BHP Billiton* [2007] VSCA 255 the Victorian Court of Appeal set aside an arbitral award on the basis that the provision of inadequate reasons constituted a manifest error of law, and that the arbitrators had engaged in technical misconduct under the *CAA* by failing to consider important evidence and submissions.

## **55. Likely Modifications to the Model Law**

SCAG has announced that the new draft legislation will be based on the Model Law supplemented by any additional provisions that are necessary or appropriate for domestic arbitration. The stated purpose is to provide a method of finally resolving disputes by commercial arbitration that is quicker, cheaper and less formal than litigation. There will be consultation with stakeholders before the states adopt the draft legislation.

Although it was originally drafted as a law for international arbitration, most of the Model Law’s provisions are equally suited to domestic arbitration. In principle, comparatively few adjustments should be required to adapt the UNCITRAL template for domestic arbitration. However, the scope and application provisions of the Model Law will certainly need to be amended, and additional ‘Model Law Plus’ provisions will probably need to be drafted to address the interaction of the new domestic arbitration laws with the *IAA*.

Certain features of the outgoing *CAAs* may also be adopted, although they are not in the Model Law. For example, a possible addition to the UNCITRAL template would be an equivalent of *CAA* s 27 (settlement of disputes otherwise than by arbitration), under which the parties may authorise the arbitrator to act as a conciliator or mediator for the purposes of achieving settlement, and may not object to the arbitrator returning to the role of ‘judge’ and continuing with the arbitration if no settlement is reached. This provision is seen as promoting the practice of mediation-arbitration (or ‘med-arb’), a hybrid method of dispute resolution used in other jurisdictions (such as the United States) with good results. Australian practitioners are, however, divided on the merits of med-arb.

Another possible candidate for Model Law Plus status is *CAA* s 26 (consolidation of arbitration proceedings), under which any party may ask the arbitrator to make orders consolidating arbitral proceedings involving the same parties and facts. The *CAA* consolidation rule is widely seen as improving the efficiency of arbitration, and conforming to the increasingly multi-party reality of modern commercial disputes. The availability of a consolidation rule in arbitration also reduces the comparative advantage of litigation, where the parties go to court safe in the knowledge that they can drag almost anybody they wish along to their once-and-for-all shouting match, and do not run the risks of conflicting awards or duplicated costs in parallel arbitral proceedings.

It is hoped that the Model Law Plus provisions of the new state arbitration laws will include a consolidation rule. Section 24 of the *IAA* provides for consolidation of international

proceedings, and such a provision could be tacked onto the state Acts. Hong Kong, New Zealand and British Columbia have made similar additions to the UNCITRAL template.

## **56. Conclusion**

The adoption of the Model Law at the state level is a positive step forward for the practice of arbitration in Australia. The best result for users would be for the Model Law to be adopted outright (that is, with an amendment to Art 1 (scope) only), in which case Australia would become monist. Even if the substantive changes are made, so long as the key features of the Model Law are retained and the 'manifest error of law' rule is left out, the law will be better. Given the Commonwealth Attorney-General's interest in Australia becoming a leading seat of international arbitration, it is likely that only minimal amendments will be made to the UNCITRAL template.

If the anticipated changes are made the new state arbitration laws will:

- reduce court intervention in domestic arbitral proceedings;
- give users of arbitration more freedom to adopt or create procedures that meet the needs of their dispute; and
- increase the finality of arbitral awards by limiting the grounds on which the losing party can seek to have the award set aside.

With the Model Law on the horizon, users of domestic arbitration may wish to get the benefit of the new framework in future disputes. But without the new Acts in place, the parties cannot submit to them. The parties can, however, reduce the prospect of their dispute being governed by the outgoing *CAAs*. The best way to do this is by drafting the arbitration clauses in their commercial contracts to refer to the state arbitration law in force at the time the dispute arises. This way, once the new laws are passed the parties should not be stuck with the *CAAs*, even though they were in force at the time they contracted.

**FREE MOVEMENT OF CAPITAL AND GOLDEN SHARES:  
A NEW PERSPECTIVE ON CORPORATE CONTROL?  
(JOINED CASES C-463/04 AND C-464/04,  
*FEDERCONSUMATORI AND OTHERS V COMUNE DI  
MILANO*)**

**Alessandro Spano<sup>\*</sup>**

**Abstract**

This case note comments on the judgement delivered by the European Court of Justice in *Federconsumatori and others v Comune di Milano* (Joined Cases C-463/04 and C-464/04) concerning the compatibility of Art 2449 of the Italian Civil Code with the free movement of capital. In this judgment, the court confirms its previous jurisprudence on golden shares and clarifies the impact that the freedom has on national provisions which, by derogating from ordinary company law, confer special rights directly on the State or public bodies. The relevance of the free movement of capital for national company law, however, goes far beyond the retention of special rights in listed companies by public entities. Restrictions on the freedom may also arise from the application of provisions of national law by private parties or from decisions taken by the company's shareholders which try to restrict access to the market in corporate control.

## **57. Introduction**

So far the debate over golden shares has focused on special rights and powers that the State and public bodies continue to hold in privatised companies. In its golden shares case law, the European Court of Justice pointed out that such special rights, when not justified by mandatory reasons of public interest, constitute a restriction on the free movement of capital within the meaning of Art 56 of the EC Treaty, since they potentially make an investment in limited companies less attractive.<sup>1</sup>

These rights may take different forms. They can be attached to a special share or, as in the case under discussion, be vested in the State directly by a provision of national law. In this regard, in *Federconsumatori and others v Comune di Milano*,<sup>2</sup> the European Court of Justice

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<sup>\*</sup>The author is a Visiting Research Fellow at the School of Law of King's College, London, and lectures in EU Law at the Faculty of Laws of the University College London. In 2009 he was awarded the EU Science and Technology Fellowship Programme in China (EU STFP China) for the establishment of a Sino-European Working Group in the areas of World Trade Law and Competition Law between the School of Law of King's College, London, and the Tsinghua University of Beijing. The author thanks Professor Andrea Biondi and Professor Piet Eeckhout, co-directors of the Centre of European Law at King's College, London, for their support of this work. Email address: [alessandro.spano@kcl.ac.uk](mailto:alessandro.spano@kcl.ac.uk).

<sup>1</sup> With reference to the case law of the European Court of Justice on golden shares, see Case C-58/99, *Commission v Italy* [2000] ECR I-3811; Case C-367/98, *Commission v Portugal* [2002] ECR I-4731; Case C-483/99, *Commission v France* [2002] ECR I-4781; Case C-503/99, *Commission v Belgium* [2002] ECR I-4809; Case C-463/00, *Commission v Spain* [2003] ECR I-4581; Case C-98/01, *Commission v United Kingdom* [2003] ECR I-4641; Case C-174/04, *Commission v Italy* [2005] ECR I-4933; Joined Cases C-282/04 and C-283/04, *Commission v Netherlands* [2006] ECR I-9141; Case C-112/05, *Commission v Germany* [2007] ECR I-0000.

<sup>2</sup> Joined Cases C-463/04 and C-464/04, *Federconsumatori and others v Comune di Milano* [2007] ECR I-10419.

held that Art 2449 of the Italian Civil Code, which allows the State and public bodies to participate in a more significant way in the activity of the board of directors of a company limited by shares than their status as shareholders would normally allow, consists of a restriction on the free movement of capital between member states and it is, therefore, contrary to Art 56 of the EC Treaty. By conferring on public shareholders an instrument to restrict the effective participation of other shareholders in the management of a limited company, Art 2449 of the Civil Code is, in fact, liable to deter investors from other member states to invest in that company.

The importance of the case, however, does not only stem from the outcome of the judgment. Rather, its significance lies in the seeds sown by the approach and the motivations adopted by the court in its ruling that open a new perspective for the relationships between the provisions on the free movement of capital and national company law. In this sense, in *Federconsumatori and others v Comune di Milano*, the court not only confirms its previous jurisprudence but also clarifies the impact that the free movement of capital has on national provisions which, by derogating from ordinary company law, confer special rights directly on the State, or allow the incorporation of such rights in the articles of association of a limited company for the exclusive benefit of the State or public bodies.

Furthermore, the reasoning of the court clearly shows that the free movement of capital might be restricted by all national provisions which make an investment in limited companies less attractive. The relevance of the freedom for national company law, therefore, goes far beyond the retention of special rights in listed companies by the State or public bodies. The decision of the court cannot be limited only to special powers granted to public investors by national law. The discussion focuses now on the potential impact that the free movement of capital may also have on those restrictive arrangements arising from the application of provisions of national law by private parties or from a decision taken by the company's shareholders, which try to restrict access to the market in corporate control.

## **58. Factual Background**

AEM SpA (Azienda Elettrica Milanese SpA) is a company that was set up by the Comune di Milano (Municipality of Milan) in 1996 that operates as a distributor of gas and electricity. When AEM was first listed on the stock market in 1998, the Comune di Milano held 51% of the company's capital. As AEM's privatisation continued, in 2004 the Comune di Milano decided to reduce its shareholding to 33.4%, but made the transfer of its shares conditional on the prior amendment of the company's articles of association.

Article 2449 of the Italian Civil Code provides that the articles of association of a limited company in which the State or public bodies participate as shareholders may confer on them the power directly to appoint one or more directors.

Pursuant to such a measure and in accordance with Art 4 of Law No 474/94, at an extraordinary general meeting of AEM on 29 April 2004, the articles of association of the company were amended by inserting the exclusive right for the Comune di Milano to appoint directly, in proportion to its shareholding, directors not exceeding one quarter of the members of the board of directors of AEM, and to participate in the election on the basis of lists of directors not directly appointed by it.

The result was that, despite its minority shareholding, the Comune di Milano was able to retain the permanent control of the company by having *de facto* the possibility to veto any

proposal to amend the provisions of the articles of association related to the system for the appointment of the board of directors.

Consumers' associations and small shareholders brought proceedings against the Comune di Milano before the national courts, since they considered that its privileged position had the effect to discourage investors from purchasing shares in AEM and, consequently, to reduce the value of their shareholding in the company.

The main issue raised before the European Court of Justice was whether Art 2449 of the Italian Civil Code, which enabled the State or public bodies to retain a power of control in a company limited by shares that was disproportionate to their shareholding, could be held to be compatible with Art 56 of the EC Treaty as interpreted by the court in golden shares case law.

## 59. The Court's Judgement

In its judgement, the European Court of Justice first recalled that, according to settled case law, Art 56(1) of the EC Treaty lays down a general prohibition on restrictions on the free movement of capital between member states.<sup>3</sup> More specifically, the court reaffirmed that national measures which are liable to prevent or limit the acquisition of shares in a listed company or to discourage potential investors of other member states from investing in that company consist of restrictions within the meaning of Art 56(1) of the EC Treaty.<sup>4</sup>

The court found that a provision such as Art 2449 of the Italian Civil Code clearly amounted to such a restriction. By allowing the State and public bodies to participate more significantly in the activity of the board of directors of a limited company than their status as shareholders would have normally allowed, Art 2449 gave to public shareholders the possibility to exercise an influence exceeding their levels of investment and, as a consequence, it limited the possibility of other shareholders to participate effectively in the management of the company.<sup>5</sup>

The fact that the right of direct appointment of the Comune di Milano was proportional to its shareholding in AEM and that it could be exercised only as regards a maximum of one quarter of the members of its board of directors did not take away the restrictive character of the Italian legislation.

Article 2449 of the Civil Code, in conjunction with Art 4 of Law No 474/1994, conferred exclusively on the Comune di Milano the possibility to participate in a more significant way in the activities of the board of directors of AEM. Accordingly, by limiting the effective participation of shareholders other than the Comune di Milano in the management of the company, Art 2449 was liable to deter direct investors from other member states from investing in the company's capital and it, therefore, amounted to a restriction on free movement of capital within the meaning of Art 56(1) of the EC Treaty.<sup>6</sup>

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<sup>3</sup> At [19]. See also, *inter alia*, *Commission v Netherlands*, *supra* n 1, at [18], and the case-law cited; and *Commission v Germany*, *supra* n 1.

<sup>4</sup> At [21]. See also *Commission v Germany*, *supra* n 1, at [19], and the case law cited.

<sup>5</sup> At [23]–[24]. The court referred by analogy to *Commission v Germany*, *supra* n 1, at [62].

<sup>6</sup> At [28]–[29]. In this regard, see also *Commission v Germany*, *supra* n 1, at [66].

In the second part of its judgement, the court examined the justifications put forward by the Comune di Milano and the Italian Government asserting that, first, the privileged position of the Comune di Milano in AEM was based on a provision of ordinary company law and, second, that the application of Art 2449 of the Italian Civil Code was not obligatory but the special right of the Comune di Milano had been conferred voluntarily on it by the shareholders of the company in a general meeting.

The court dismissed all these arguments. First, it held that the rule contained in Art 2449, although falling within the scope of the general rules of national company law, amounted to a derogation from ordinary company law in so far as the latter did not provide an identical rule applicable to private shareholders. Accordingly, the mere fact that the right of appointment of the Comune di Milano resulted from a provision of national law conferring special powers on the State or public bodies when detaining a holding in a company limited by shares, did not preclude the application of Art 56 of the EC Treaty to the contested provision.<sup>7</sup>

Second, the court pointed out that, although the Comune di Milano had the majority required to have its right of direct appointment of AEM's directors as included in the company's articles of association only with the consent of the other shareholders, it was only by virtue of the provision in dispute that it could, unlike an ordinary shareholder, participate in the management of the company more significantly than its status as shareholder would have normally allowed.<sup>8</sup>

The argument that the special right conferred on the Comune di Milano could be amended upon a subsequent revision of AEM's articles of association was also immaterial. As the court clarified, an investor would be able to repeal such a right only if its investment in the company was so great as to grant him the majority necessary to amend the company's articles of association. However, this was *de facto* impossible as long as the Comune di Milano retained its 33.4% shareholding. The court concluded by stating that, even though from a formal point of view the privileged position of the Comune di Milano resulted by a decision taken by AEM's shareholders in a general meeting, that decision must be seen just as an instrument of which the Comune di Milano was able to make use only by reason of the existence of the contested legislation.<sup>9</sup>

In the final part of its judgment, as it had already ruled on this in its previous case law, the court recalled that the free movement of capital may only be restricted by national measures justified on the grounds set out in Art 58 of the EC Treaty or by overriding reasons in the general interest to the extent that there are no Community harmonising measures providing for measures necessary to ensure the protection of those interests.<sup>10</sup>

Although in the absence of Community harmonisation, it is generally for the member states to determine the degree of protection and the methods to defend such legitimate interests; however, in doing so, they must act within the limits of the treaty and must, in particular, observe the principle of proportionality requiring that the measures adopted be appropriate to attain their objective and not go beyond what is necessary to its attainment.<sup>11</sup>

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<sup>7</sup> At [31]–[32].

<sup>8</sup> At [34].

<sup>9</sup> At [35]–[38].

<sup>10</sup> At [39]. See also *Commission v Germany*, *supra* n 1, at [72], and the case law cited.

<sup>11</sup> At [40].

The court further held that, depending on the circumstances, the retention by member states of a degree of influence within former state-owned enterprises may be justified in cases where these undertakings operate in fields involving the provision of services in the public interest or strategic services.<sup>12</sup> However, since Art 2449 of the Civil Code did not make inclusion in the articles of association of a limited company of the right for the State or public bodies detaining shares in that company to appoint directly one or more directors subject to any condition, such a provision could not be justified.<sup>13</sup>

## 60. Analysis

Golden shares are a much debated issue since the European Court of Justice delivered its first ruling on golden shares in 2000.<sup>14</sup> Golden shares (in German, ‘*goldene aktien*’, in French, ‘*actions spécifiques*’) consist of special rights conferred upon the State or other public entities granting a certain degree of control in privatised companies. State control in companies limited by shares is, in fact, a widespread phenomenon in Europe that finds its origins in the process of privatisation of former state-owned enterprises.

The main purpose of golden shares is the protection of the strategic interests of the State by maintaining special rights or powers in privatised companies. However, although the expression ‘golden shares’ refers to the ownership of shares by the State or other public bodies, golden shares do not necessarily require the possession of a real shareholding. Special rights can be maintained by the State even without the necessity to hold a single share and may be conferred upon it even when the State sells its shares.<sup>15</sup>

Since such special rights consist of a derogation from ordinary company law, they may raise tension between the interests of the State and the provisions of the EC Treaty on the freedom of establishment and the free movement of capital.<sup>16</sup> In fact, although golden shares are not prohibited *per se*, in order to be held compatible with the principles of free movement they must satisfy strict criteria legality.<sup>17</sup> In *Commission v France*, the European Court of Justice

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<sup>12</sup> At [41]. See also *Commission v Spain*, *supra* n 1, at [66], and the case-law cited.

<sup>13</sup> At [42].

<sup>14</sup> *Commission v Italy*, *supra* n 1. Three other important judgments on golden shares were further delivered by the European Court of Justice on 4 June 2002: *Commission v Portugal*; *Commission v France*; and *Commission v Belgium* (*supra* n 1). For an analysis of these cases, see V Kronenberger, ‘The Rise of the “Golden” Age of Free Movement of Capital: A Comment on the Golden Shares Judgments of the Court of Justice of the European Communities’ (2003) 4 *EBOR* 115–35.

<sup>15</sup> Special rights can be vested in the State, for instance, by provisions of national law or a specific privatisation Act and they may result from the articles of association of a company or administrative procedure. See P Camara, ‘The End of the ‘Golden’ Age of Privatisations? The Recent ECJ Decisions on Golden Shares’ (2002) *EBOR* 3; S Grundmann and F Möslein, *Golden Shares — State Control in Privatised Companies: Comparative Law, European Law and Policy Aspects* (April 2003), <<http://www.ssrn.com/abstract=410580>> at 9 May 2009.

<sup>16</sup> With reference to the relationship between Arts 56 and 43 of the EC Treaty, see S Grundmann and F Möslein, *supra* n 15, at 19.

<sup>17</sup> As far as their relationship with the free movement of capital is concerned, the legal basis is contained in Arts 56–60 of the EC Treaty. Despite its importance for the establishment of a fully functioning internal market the free movement of capital witnessed a slower development than the other fundamental freedoms. Only at the beginning of the 1990s, with the increasing dynamics of financial markets and the growing number of cross-border investments, the adoption of a common policy for capital transactions has been recognised of prior importance in Europe. In addition to this, the implementation of secondary legislation and a growing body of case law of the European Court of Justice further boosted the development of the freedom. For further rules on the free movement of capital see, for instance, the Council Directive 88/361/EEC of 24 June 1988 for the

pointed out that Art 56 of the EC Treaty lays down a general prohibition on restrictions on the movement of capital between member states.<sup>18</sup> Its scope goes beyond the mere elimination of unequal treatment on the basis of nationality and it is, therefore, irrelevant whether the measures in question affect without distinction domestic shareholders or shareholders having the nationality of another member state. Accordingly, the prohibition contained in Art 56 regards not only discriminatory rules on grounds of nationality but each measure restricting a cross-border transfer of capital.

In its subsequent golden shares cases, the court further clarified and developed the concept of restrictions on the free movement of capital. It held that:

[N]ational measures must be regarded as 'restrictions' within the meaning of Article 56(1) EC if they are liable to prevent or limit the acquisition of shares in the undertakings concerned or to deter investors of other Member States from investing in their capital.<sup>19</sup>

According to such a definition, the court seems to consider even more generally that all rules which potentially affect free access to the market may be seen as restrictions on the free movement of capital within the meaning of Art 56(1) of the EC Treaty.

The decision of the court in *Federconsumatori and others v Comune di Milano* reflects this approach. A national provision such as Art 2449 of the Italian Civil Code clearly consisted of such a restriction. By enabling, in fact, public shareholders to participate more significantly in the activity of the board of directors of a company limited by shares than their status as shareholders would have normally allowed, Art 2449 of the Civil Code gave them an instrument to exercise an influence exceeding their levels of investment. Accordingly, by reducing the influence of the other shareholders below a level commensurate with their own levels of investment, it was liable to discourage an investor from buying shares in the company.

The decision to dismiss the argument that the privileged position of the Comune di Milano was not contrary to the free movement of capital since it was based on a provision of national law is also in line with the solutions adopted by the court in its previous case law.

The fact that special rights are conferred upon the State or public bodies by a provision of national company law does not preclude the application of Art 56 of the EC Treaty. In order to determine whether the privileged position enjoyed by the State or by public bodies consists of a restriction on the free movement of capital, it is irrelevant how such a position is conferred or what legal form it takes. Accordingly, even when the State operates within the framework of its domestic company law, its special powers may amount to a restriction within the meaning of Art 56. Otherwise, the State could use private law to obtain a power of control in companies limited by shares that is disproportionate to its shareholding and, consequently, its special powers would become an instrument to operate on the market as a regulator rather than as a participant.

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implementation of Art 67 (now Art 56 EC) of the Treaty, *Official Journal L* 178, 5–18; and the Communication of the Commission on Certain Legal Aspects Concerning Intra-EU Investment, 1997, *Official Journal C* 220, 15–18.

<sup>18</sup> *Commission v France*, *supra* n 1, at [40].

<sup>19</sup> *Commission v Portugal* at [45]; *Commission v France* at [41]; *Commission v Spain* at [61]; *Commission v United Kingdom* at [47]; *Commission v Italy* at [30], [31]; *Commission v Netherlands* at [20]; *Commission v Germany* at [21] (*supra* n 1).

In so far as public bodies are subject to the normal market rules, the fact that they own shares in a limited company does not make it less attractive for private investors to invest in that company. However, although member states are entitled by the treaty to maintain the ownership of certain companies, when they decide to open up a particular sector of the economy and the privatisation of public enterprises occurs, they must act in conformity with the provisions of the treaty that require the respect of the principles of openness and non-discrimination. More specifically, the rules on free movement prohibit those special forms of market control over former state-owned enterprises that, by granting only selective and potentially discriminatory access to a substantial part of the national market, are liable to deter investors from other member states to invest in those companies.<sup>20</sup> Accordingly, as in the context of *Federconsumatori and others v Comune di Milano*, provisions of national law from which only the State and public bodies may enjoy a privileged position consist of a derogation from ordinary company law and amount, by definition, to a restriction on the free movement of capital.<sup>21</sup> The State cannot, therefore, adopt legislation to confer on it or public bodies special rights, as regards the control of a limited company, in relation to ordinary shareholders.<sup>22</sup> This prohibition does not apply only to provisions of national law which confer special rights directly to the State or public bodies,<sup>23</sup> but also to those provisions which allow incorporating such rights in the articles of association of a company for the exclusive benefit of public entities.<sup>24</sup>

In this regard, the decision of the court reflects the approach taken in its previous judgment, *Commission v United Kingdom*, when it found the United Kingdom Government's golden shares in BAA to be contrary to the rules on the free movement of capital.<sup>25</sup> The case focused on two aspects of BAA's articles of association. First, the requirement to obtain prior approval from the United Kingdom Government in relation to certain key decisions (for example, winding-up or disposal of an airport); and, second, an article preventing the acquisition of more than 15% of the voting shares in the company. The government had asserted that BAA's articles of association were not contrary to Community law because the rights exercisable by the Secretary of State under its special share did not affect access to the market and they were governed by provisions of private company law and not of public law. The court found that the restrictions at issue did not arise as the result of the normal operation of company law. BAA's articles of association had to be approved by the Secretary of State pursuant to the Airports Act 1986 (UK). Under such circumstances, the United Kingdom acted, therefore, as a public authority.<sup>26</sup>

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<sup>20</sup> In this sense, see [25]–[26] of the Opinion of Advocate General Maduro, delivered on 7 September 2006 in *Federconsumatori and others v Comune di Milano*.

<sup>21</sup> *Ibid* at [30].

<sup>22</sup> The retention by the states of a degree of influence in privatised companies may be only justified in situations where such companies operate in fields related to the provision of services in the public interest or strategic services. See *Commission v Spain*, *supra* n 1, at [66], and the case-law cited.

<sup>23</sup> In this regard, see *Commission v Portugal*; *Commission v France*; *Commission v Spain*; *Commission v Belgium* (*supra* n 1).

<sup>24</sup> See *Commission v United Kingdom*, *supra* n 1.

<sup>25</sup> *Ibid*.

<sup>26</sup> In addition to this, the court also rejected the argument of the United Kingdom Government that the concerned restrictions were to be considered as selling arrangements under the *Keck and Mithouard* case law (Cases C-267/268/91, *Keck and Mithouard* [1993] ECR I-6097) in the area of the free movement of goods. See *Commission v United Kingdom*, *supra* n 1, at [34].

In its case law on golden shares, the court has, therefore, clarified the impact of Art 56(1) of the EC Treaty on national company law in cases where national rules confer special rights directly to the State or they allow to incorporate such rights in the articles of association of a company for the sole benefit of the State or public bodies. However, it still remains unclear the influence that the free movement of capital may have on company law in those situations where restrictions arise primarily from a decision of the company or its shareholders based on provisions of ordinary company law.

Most of the provisions related to limited companies are likely to restrict the establishment or movement of companies. However, the limits set up by the provisions of the treaty in the area of the free movement of capital could be seen as a restriction of the autonomy of private investors and their capability to pursue a business activity in a certain way.

Being aware of the potential impact that the free movement of capital may have on national company law and its implications for private autonomy, the court in *Federconsumatori and others v Comune di Milano* adopted a cautious approach on the matter when it stated:<sup>27</sup>

Given that ... the national court bases its reasoning on the premise that the rule in Article 2449 of the Civil Code derogates from ordinary company law, there is no need to examine what the situation would be if that right were to give all shareholders, including private shareholders, an identical right of appointment.

The question, therefore, remains if there is a restriction anyway in such circumstances. In general terms, it is unclear, for instance, whether or not it is possible to derogate from the rule 'one share one vote' and to confer upon a shareholder more voting rights for his or her share than other shareholders, or which limits a company encounters when it set up its own articles of association.

Whether some restrictions to the free movement of capital may result from the application of national law by private parties, other restrictions may simply arise from a decision of the company's shareholders which intend to restrict access to the company.

The golden share cases indicate that most probably voting caps, management discretion in adopting defensive measures or the mandatory nature of certain corporate provisions shall be tested under Community law. The impact that the provisions of the treaty in the area of the free movement of capital may have on national company law shall, therefore, also depend on whether or not their horizontal direct effect should be recognised.

Although the court has not yet ruled on the horizontal direct effect of the free movement of capital, however, it would appear that discriminations on the ground of nationality should be prohibited. This conclusion may be drawn from Art 12 of the EC Treaty as interpreted by the European Court of Justice in *Angonese*.<sup>28</sup>

Furthermore, in relation to the horizontal direct effect of Art 43 of the EC Treaty, it is worth mentioning the recent *Viking Laval* case.<sup>29</sup> The European Court of Justice in this ruling clarified, in fact, that associations or organisations not governed by public law may by their behaviours create barriers to the exercise of Community rights. Accordingly and by referring

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<sup>27</sup> At [31].

<sup>28</sup> See Case C-281/98, *Angonese* [2000] ECR I-4139 at [35].

<sup>29</sup> See Case C-438/05, *International Transport Workers' Federation and Finnish Seaman's Union* [2007] ECR I-000.

to Case 43/75 *Defrenne* and to its case law on the free movement of goods, the court concluded that Art 43 of the EC Treaty may be relied on by a private undertaking against a trade union or an association of trade unions. The court also added that although a restriction may, in principle, be justified by an overriding reason of public interest, such as the protection of workers, it must, however, be suitable to attain the legitimate objective pursued and not go beyond what is necessary to achieve that objective. It must be borne in mind that, as is apparent from paras 35 and 36 of the judgment, the collective action taken by FSU and ITF is aimed at the conclusion of an agreement which is meant to regulate the work of Viking's employees collectively, and, that those two trade unions are organisations which are not public law entities but exercise the legal autonomy conferred on them, *inter alia*, by national law.

It remains controversial, however, whether this jurisprudence could also be extended to situations of non-discriminatory restrictions in the area of the free movement of capital. Should horizontal direct effect be recognised, a major issue would arise, for instance, concerning the questions in which cases and under which conditions private parties could justify restrictions of the freedom. Whether member states can justify restrictions based on reasons of public interest, the challenging question to answer would be which arguments private individuals could put forward to defend the compatibility of restrictions with the provisions of the treaty.<sup>30</sup>

An alternative solution to the issue of horizontal direct effect and the free movement of capital may perhaps be found in Art 10 of the EC Treaty. According to such an article, member states shall take all appropriate measures, whether general or particular, to ensure the fulfilment of the obligations arising out of the treaty or resulting from action taken by the institutions of the Community. They shall also facilitate the achievement of the Community's tasks and abstain from any measure which could jeopardise the attainment of the treaty's objectives.

Furthermore, the court established that according to Art 28 of the EC Treaty (ex-Art 30) member states must not merely abstain from adopting measures or engaging in conduct liable to constitute an obstacle to trade but also, when Art 28 is read with Art 10 of the Treaty (ex-Art 5), they must take all necessary and appropriate measures to ensure that that fundamental freedom is respected on their territory.<sup>31</sup> Although this solution has been applied by the court in the area of the free movement of goods, however, in *Schmidberger* the court expressly referred to restrictions on the exercise of a fundamental freedom.<sup>32</sup> This would entail that member states assume the obligation to ensure within their territory the full application and respect of the fundamental freedoms by both public and private parties. Although they remain free to set up the content of their national law, however, national legislation must always respect the principles of the treaty. When the national legislator formulates the provisions of company law, it also sets out the limits of action of private parties and, in doing this, it is bound by the fundamental freedoms. This would be so also when it would decide to confer upon private parties specific powers which make them capable to restrict the rights or affect the position of other individuals. Member states, however, would still be able to justify

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<sup>30</sup> For a discussion on the issue of free movement of capital and horizontal direct effect, see M Andenas, T Gutt and M Pannier, 'Free Movement of Capital and National Company Law' (2005) 16 *EBLR* 4 at 776–7.

<sup>31</sup> Case C-265/95, *Commission v France* [1997] ECR I-6959 at [32].

<sup>32</sup> Case C-112/00, *Schmidberger* [2003] ECR I-5659 at [62].

restrictions on the free movement of capital on the ground of reasons of public interest like, for instance, the protection of shareholders interests.<sup>33</sup>

On the one hand, such an approach would offer an alternative solution to the controversial issue of the horizontal direct effect of the free movement of capital; on the other hand, it would provide an answer to the need to recognise at least an indirect effect of the freedom on private parties. Member states would continue to be the only parties responsible for justifying restrictions on the free movement of capital and private parties would continue to act within the limits of the provisions of national company law, but previously tested under the principles of Community Law.

Although such a solution clearly presents various advantages, however, its ultimate outcome shall obviously also depend on the level of harmonisation that the Community shall be able to achieve in the area of the free movement of capital and on the capacity of member states to implement in full secondary legislation adopted for this purpose.

By referring to these issues, it is worth mentioning the European Directive on Takeover Bids, which has as its main purpose the creation of a level playing field at European level in the area of corporate control and, more specifically, in that of takeover bids.<sup>34</sup> In this regard, two of the core rules contained in the Directive are the board neutrality rule,<sup>35</sup> and the break-through rule,<sup>36</sup> which have as objectives to neutralise most of the potential barriers and defensive mechanisms which can be adopted by the target company in the pre- and post-bid period.<sup>37</sup>

The solutions adopted in the Directive, however, reflect a political compromise between different national codes on takeover bids and fail to introduce stringent rules in this area. The Directive leaves, in fact, to member states the possibility to opt out from both the board neutrality rule and the break-through rule. Furthermore, the reciprocity rule contained in Art 12 of the Directive allows member states to decide whether to apply less stringent measures than those arising from the two rules when the bidding company is not subject to the same kind of prohibitions or restrictions.

This fact may have a strong impact on the process of integration of the European market in the field of corporate control. The decision of member states to opt out by these rules and to apply more flexible measures at national level could, in fact, undermine the objective of eliminating most of the behaviours restricting access to markets in corporate control, and nullify the attempt to achieve a full harmonisation in this area.

In this context, the discussion over the relationship between the free movement of capital and national company law comes up again. Whether or not, in fact, member states would decide to apply more flexible rules at a national level, the European Court of Justice should intervene to assess the compatibility of such measures with the provisions of the treaty on capital. The question which remains to be answered is, therefore, whether or not the court shall decide to enforce Art 56(1) also in horizontal situations.

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<sup>33</sup> M Andenas, T Gutt and M Pannier, *supra* n 29, at 777.

<sup>34</sup> Directive 2004/25/EC on Takeover Bids OJ [2004] L 142/12.

<sup>35</sup> Directive, Art 9.

<sup>36</sup> Directive, Art 11.

<sup>37</sup> For a detailed analysis of the European Directive on Takeover Bids, see T Papadopoulos, 'Legal Aspects of the Breakthrough Rule of the European Takeover Bid Directive' in *Takeover Regulation: A Legal Approach* (2008).

Should this happen, such a solution would provide a further challenge for the development and application of the free movement of capital. Whether or not, in fact, the lack of an effective and comprehensive legislative intervention in the field of corporate control would persist, the creation of a European common market in this area would be principally achieved, as it happened in the area of the free movement of goods, through a process of negative harmonisation rather than a process of positive integration. In this sense, the decision of the court in *Federconsumatori and others v Comune di Milano* may, therefore, represent one of the first steps in the direction of a wider interpretation of the scope of the provisions on the free movement of capital.



# **Book Reviews**

**Hanneke van Schooten and Jonathan Verschuuren (eds), *International Governance and Law: State Regulation and Non-State Law*, Cheltenham, United Kingdom, Edward Elgar Publishing, 2008, ISBN 9781847207272.**

*International Governance and Law* is the product of the Centre for Legislative Studies, Tilburg University, the Netherlands. This multi-disciplinary research centre focuses on the relationship between state legislation (state law) and law emerging from other sources (non-state law). This book, edited by Hanneke van Schooten and Jonathan Vershuuren, questions the extent to which non-state law currently influences state law, and asks what the consequences of non-state law are for state regulators. The contributors are an international group of academics brought together for the specific purpose of considering these questions. The first part of the book provides the theoretical basis for the study of the relationship between state and non-state law. The second part is a series of chapters detailing empirical research in this area of legal sociology.

The theoretical part of the book defines non-state law and its goals, functions, legitimacy and relationship to state law. Chapter 2 asks ‘What is non-state law?’. It reviews the socio-legal literature on non-state law and locates the study of non-state law in the wider context of the study of legal pluralism. It also develops an elegant conceptual map which helps the reader to visualise the integration of state and non-state law. Chapter 3 analyses the work of Philip Selznik, one of the first legal philosophers to attempt to develop a sociology of the rule of law. Author Krygier describes Selznik as the most eminent author in this field of study and his work sheds a great deal of light on the relationship between state and non-state. In Chapter 4, the author, Takema, uses Llewellyn’s theory of law-jobs — resolving conflicts, channelling conduct, allocating authority, providing direction and incentive, and juristic method — as a framework for comparing the functionality of state and non-state law. He provides practical examples which illustrate the differences and similarities between state and non-state law. Chapter 5 explores the debate between Eugen Erlich (1862–1922) and Hans Kelsen (1881–1973) over whether laws derive from society or the state. Author Van Klink briefly sketches the competing conceptions of law and argues that Kelsen’s conception of law is superior to Erlich’s in this era of globalisation. Chapter 6 provides a legal historical perspective on non-state law by exploring Erlich’s historical argument that Roman civil law in the time of the Republic was non-state law.

Each of the empirical chapters provides examples of non-state law in various fields of law and considers the implications of these sources of law for state regulators. Chapter 7 uses five different conceptual frameworks to explore the recent reconfiguration of environmental regulation and the role played by non-state law. Chapter 8 explores the interaction between soft and hard law in the context of state and non-state regulation of nanotechnology in the United Kingdom. Chapter 9 is a case study on the way that state and non-state actors in the Australian state of New South Wales worked together to force barristers to comply with Australian taxation laws. Chapter 10 considers Australian native title law. The author argues that Australian native title law discriminates against indigenous people because even though native title was recognised by the Australian High Court, it is still viewed as non-state law and therefore seen as inferior and subordinate to the common law and statutory framework. Chapter 11 is a revealing case study on the relationship between state and non-state regulation of passive euthanasia in Germany and the implications for medical practitioners. The practice in Germany is then compared to the law in the United States and the Netherlands. Chapter 12 considers the influence of court judgements on non-state law in the Netherlands.

In Chapter 13, the editors draw the theoretical and empirical parts of the book together to propose answers to the questions that are the main focus of the book. They conclude that from a theoretical perspective, state and non-state law is becoming increasingly intertwined. The editors argue that in many policy areas, non-state law is taking on the characteristics of state law and is seen as increasingly legitimate or even 'legal'. As a consequence, the editors suggest that in policy areas such as nanotechnology, where non-state law has strength and legitimacy, state regulation should focus on supporting the development and application of non-state law.

The book is consistently well written, with extensive in-text referencing and bibliographies at the end of each chapter. The empirical chapters frequently draw on the concepts and frameworks explained in the theoretical part, giving the book a level of cohesiveness that is rarely found in works of this nature. This book has practical value for state and non-state regulators in general as well as in specific policy areas. It is also a valuable resource for academics and students of legal theory, regulation and comparative law.

Claire Vinten

**Andrew D Mitchell, *Legal Principles in WTO Disputes*, United Kingdom, Cambridge University Press, 2008, ISBN 9780521873260**

This book provides a detailed insight into how the World Trade Organization (WTO) body of rules interacts with public international law. The author, Dr Mitchell, explores how the WTO panel and appellate boards have applied legal principles in dispute resolution. He outlines how such principles are often used inconsistently or inappropriately, and then suggests a framework that is likely to ensure greater quality in the WTO's dispute resolution process.

Part I of the book establishes a proposed framework for the application of WTO principles. Chapter 2 defines three alternative sources of principles that the WTO should draw from. These areas are WTO law, customary international law and general law. In this section of the book, Dr Mitchell makes a clear distinction between 'principles' and 'rules' and explores how the application of legal principles, from the areas above, can assist a tribunal's legal interpretation of WTO provisions in a more consistent manner.

Part II of the book applies Dr Mitchell's proposed framework through in-depth case study. Four specific principles (good faith, due process, proportionality and differential treatment) are analysed by Dr Mitchell. First, he outlines how these principles are currently being applied in WTO dispute cases. Then, through application of the proposed framework defined in Part I, he highlights how the principles could be better applied by the WTO. The apparent result appears to be a more justifiable and predictable decision-making process.

However, the book seems to take an overly academic approach to WTO jurisprudence. In a body such as the WTO, the political and economic exigencies of a decision are of the utmost importance. However, surgically dissecting the application of traditionally nebulous public international law concepts (such as good faith) in an intensely pragmatic body of law may leave the reader with the sense that Dr Mitchell's approach is somewhat divorced from reality.

Dean Tingey

**Gerard McCormack, *Corporate Rescue Law — An Anglo-American Perspective*, Cheltenham, United Kingdom, Edward Elgar Publishing, 2008, ISBN 9781847202741**

This book offers a detailed, comparative critique of bankruptcy law in the United States and the United Kingdom. The United States has been characterised as pro-debtor while the United Kingdom has the reputation of being pro-creditor. Gerard McCormack challenges these views, describing them as potentially misleading over-simplifications.

Following the introduction, Chapter 2 is devoted to the main features of corporate restructuring law in the United Kingdom. The dramatic changes, caused mainly by the Enterprise Act 2002 (UK), are placed into the context of the Labour Government's policy of making the United Kingdom the best place in the world to do business. At the same time, the government feared a downturn in the economy so new legislation was put in place to support and strengthen the economy while the government implemented an insolvency regime that encouraged honest, but unsuccessful, entrepreneurs to preserve, despite initial failure. The discussion follows on with a section devoted to the receivership aspects of business rescue, with relevant case law citations. An explanation of the increased application of administration as a means to keep a business as a going concern protected from debtor actions, or how to effectively re-distribute assets before liquidation, is given, with a critique of the outcomes.

Chapter 3 gives an enlightening explanation of the features of the United States law on corporate reorganisation, held within Chapter 11 of the United States Bankruptcy Code. The ability of United States corporations to use Chapter 11 for strategic reasons, while adhering to the good faith principle, is touched upon as a means to protect the corporation from immediate litigation. The views of Chapter 11's critics are discussed, with particular focus on the possible abuse by managers who advance their own welfare at the expense of the corporation's stakeholders and creditors. Possible reforms are discussed with scholarly references to a number of peer-reviewed articles.

The author goes on to compare the corporate routes to Chapter 11 in the United States, and the administration procedure in the United Kingdom. A comparison of the United States system, where management stay in control after filing for Chapter 11, is made with the United Kingdom system of management losing control when administration is entered into. This leads into an overview of the philosophical reasoning behind the attitudes towards entrepreneurship, debt and risk taking. This allows the reader to understand why the relative forms of legislation have been developed with so much protection for the corporate decision-makers.

Towards the end of the book, the author looks at what happens to the employees of the faltering corporation in both jurisdictions. In the United States, the companies are relieved of their 'burdensome' collectively-bargained employee commitments, while the United Kingdom system aims to save jobs and offer more benefits to existing employees. The author continues to compare worker's rights by discussing pensions, employment contracts and the effects of a restructure.

The book concludes with a comparison of corporate rescue plans in the United States and the United Kingdom. The advantages and disadvantages of the two jurisdictions are presented in a clear manner, enabling the reader to grasp the essence of both systems. This book is an excellent introduction into corporate rescue law. The style is clear and easy to follow.

The inclusion of academic and legal references throughout the text enables the reader to further investigate particular lines of argument. This book is recommended for both legal practitioners and law students.

Michael Browne

**Gordon Blanke, *The Use and Utility of International Arbitration in EU Commission Merger Remedies*, Groningen, Europa Law Publishing, 2006, ISBN 907687156**

International commercial arbitration has become the predominant method of resolving international commercial disputes and is thereby an increasingly popular area of study. However, there is little academic analysis of international arbitration derived from European Commission cleared mergers (EC-merger-remedy-related arbitrations). The lack of literature on the subject may be due to the infrequent use of international arbitration to enforce European Commission merger remedies. However, it is important to study the potential uses of arbitration for a number of reasons besides the need to advise clients of all of the available options.

When companies incorporated within the European Union merge, they must abide by the European Commission's commitment decision which includes a remedy package. These remedy packages include an arbitration clause which facilitates arbitrations between the merged entity and third parties. EC-merger-remedy-related arbitration occurs when a third-party competitor claims that a merged entity has not upheld its commitments to prevent anti-competitive impacts on international markets. The purpose of such a claim is to allow the claimant to secure an enforceable arbitration award or merger remedy relatively quickly. This award should also ensure that the third party has an opportunity to compete commercially against the merged entity.

The text is divided into three parts. Part one provides some background information as to how EC-merger-remedy-related arbitrations work and the role of such arbitration in European Commission competition law. This is followed by Part two, which provides an in-depth analysis of the European Commission's use of arbitration. Chapter 3 considers how the parameters of original commitment decisions shape the type of arbitration available. Of particular note is the diagram on page 67 which provides a clear illustration and concise explanation of the complex role of an international arbitrator in EC-merger-remedy-related arbitrations. The text also provides an interesting in-depth discussion of the ways that third party competitors can benefit from EC-merger-remedy-related arbitrations.

Chapter 4 provides some guidance on how to draft suitable arbitration clauses in merging party remedy packages. The commentary is not merely based on conjecture but an evaluation of the utility of 39 Commission clearance decisions. After a discussion of the importance of accuracy when drafting arbitration clauses, the text evaluates which elements of arbitration clauses are vital for workable arbitration commitments. Following this, Chapter 5 considers how the commission assists the international tribunal to access information to make its decision, or acts as its *amicus curia*, in EC-merger-remedy-related arbitration. The text suggests how the European Commission can best act as *amicus curiae* and still uphold the private nature of arbitration.

The last part and chapter makes logical conclusions from the preceding analysis of the European Commissions' use of EC-merger-remedy-related arbitration. However, the conclusion emphasises that the European Commission uses international arbitration to protect competition within the European Union. Traditional international commercial arbitration, on the other hand, is usually commenced by parties to resolve a private and confidential business dispute. Arbitration in EC merger control is significantly different to traditional international commercial arbitration because of the need to balance community interests. The text clearly explains many differences between 'supranational arbitration' and traditional international

commercial law. Further, there is a helpful table summary of the differences which starts on page 196. On the basis of these discrepancies, the author quite convincingly argues EC-merger-remedy-related arbitrations are so atypical they are not international arbitration but 'supranational arbitration'.

The book is written clearly and employs a detailed structure with helpful headings. The author references many primary and secondary sources in the accompanying footnotes. There are also a number of helpful annexes which summarise information, provide a sample model arbitration commitment and a best practice note for the Europe Commission. Whilst the text does not define a number of basic terms such as 'EC merger control', this is appropriate given it is aimed primarily at practitioners, the European Commission and academics. Such definitions may have provided clarity but they could have also disrupted the flow and increased the length of the book, only to appear tedious to most readers. However, this serves to increase difficulty for readers who are without sufficient grounding in international commercial arbitration and European Union law. This text succeeds in being more than a mere handbook for international arbitration practitioners or those involved in the European Commission. It is a well researched, stimulating and innovative contribution to the literature on international arbitrations under European law.

Kara Churchward

**Jan Wouters and Bart De Meester, *World Trade Organization: A Legal and Institutional Analysis*, Antwerp, Intersentia, 2007, ISBN 9789050957304**

This text from Wouters and De Meester provides a refreshing input to the panoply of World Trade Organisation (WTO) introductory texts. Surrounded by a number of texts which provide an overview of the General Agreement on Tariffs and Trade (GATT) institution and a cursory contextual comment which seems little more than an afterthought, this volume has a balanced approach. The literature is often divided between ‘legal’ texts which clinically recite sections and relate it to public international law, commercial law or some other body whilst turning a blind eye to all others; and ‘political’ texts which eschew legal authority in favour of a scathing analysis of practical decisions borne of the dispute resolution process.

The balanced approach of Wouters and De Meester consistently places the WTO within its legislative matrix, in both its positive and negative aspects. It addresses the effect of the WTO upon ‘various national and international organisations’, an effect often undisclosed by texts which analyse the WTO from an international law perspective. Purporting to be an introduction to WTO discourse for non-specialist lawyers, the text introduces readers to these tensions in such a way that they are not left adrift amongst a sanitised introduction to the WTO, but kept abreast of a polemic torrent of commentary.

The text really stands above its peers by continuing this broad contextual perception throughout the text, and not simply in a standalone chapter. For example, the criticisms of the dispute resolution process section are forwarded in the same chapter as the substantive terms of the process. One cannot help but wonder whether this contextual awareness arises from the author’s location in Leuven, Belgium, close to the political hotbeds of Brussels and Vienna. This seems to have given the authors an ear and pen more attuned to the current tensions within the legislative process, and their judgment holds true even two years after its publication.

However, despite heralding the text’s astute balancing of the political and the legal, there are some drawbacks. The text focuses more on secondary than primary resources, making it more of a text to read from start to finish and to acclimatise the uninitiated, rather than for those who are quickly seeking the current state of jurisprudence. However, as a result of this, it is likely the book will hold its currency longer in a swiftly moving channel of law.

In conclusion, this book comes highly recommended for those who wish to understand the body of the WTO from either a non-specialised practitioner’s or an academic’s perspective. Rather than concentrating on disseminating cutting edge decisions, it gives a legally informed overview of legal tensions which is an excellent roadmap of the international legal mood toward the WTO regime, and the secondary resources provide ample avenue to extend beyond the text’s reach.

Dean Tingey

**Professor Leonard F M Besselink, *A Composite European Constitution*, Groningen, Europa Law Publishing, 2007, ISBN 9789076871912**

This volume is the transcription of an address given by Professor Besselink upon his inauguration to the Jean Monnet Chair in European Constitutional Law at the University of Utrecht. It has been published in this volume in English and Dutch.

The address discusses the nature of European constitutionalism. The current European Union (EU) constitution and the national and sub-national constitutions of the member states are often described as multi-level. Professor Besselink questions the adequacy of this hierarchical description as applied to mutually influential jurisdictions. He emphasises that the relationship between the EU and the member states depends on conditional acceptance of each other's legal and political orders. The author therefore suggests those constitutions should be seen as components of a composite system rather than as separate, autonomous levels.

The address critically analyses the nature of the EU and the member states in terms of three major issues: the apparent primacy of the EU; protection of fundamental rights; and the role of parliaments.

Whilst the doctrine of primacy can lead to the assumption that the EU constitution is superior to national law, the author suggests this hierarchical approach is an unnecessary solution to conflicting norms and precedents within the European order. Further, he argues the hierarchical point of view is inadequate as a number of member states do not always unconditionally accept the precedence of EU acts over their own.

The address then considers how the strict separation of the EU and the member states prevents the protection of fundamental rights. The author criticises how the European Court of Justice has maintained the dogma of autonomy and argues the EU Charter of Fundamental Rights should be made legally binding on EU institutions.

Finally, the address considers how the role of EU representatives differs from that of national parliamentary representatives. The non-democratic nature of the EU is often explained as a result of the transfer of power, balanced by political accountability. The author argues that in reality, political accountability only functions within the national political systems. He further argues that the EU and national parliamentary representatives rarely influence each other, whereas their executive counterparts often discuss international matters. The author suggests a more composite approach would increase the role of national parliaments and increase parliamentary accountability. However, he acknowledges people and politicians may be hesitant to expand the role of their parliaments.

The author initially suggests there should be a shift of paradigm from a multi-level European constitutional structure to a composite one. He explains that it would more accurately explain the complex nature of the European constitutional structures and be a source of new academic discussion and research. However, he also acknowledges that a composite constitution would have some limits and autonomous aspects. He notes that the division and exercise of powers, scope of constitutions, pluralism and historical developments need to be discussed further. Despite these issues, he hopes that a composite rather than a multi-level approach to European constitutionalism will promote academic discussion, more interdependencies between European institutions, protection of fundamental rights and greater political accountability.

*A Composite European Constitution* provides an interesting insight into European constitutional law. The address is written in a relatively non-technical manner but may be difficult to understand for those not familiar with the EU constitutional framework. However, the unique approach the author takes to European constitutionalism would complement any international law textbook. It would also make a stimulating read for any academics or students with a general interest in comparative constitutional law.

Kara Churchward

**Hans Christian Bugge and Christina Voigt (eds), *Sustainable Development in International and National Law*, Groningen, Europa Law Publishing, 2008, ISBN 9789076871844**

When dealing with issues of sustainable development in international and national law, Our Common Future, the report by the World Commission on Environment and Development (WCED), provided an overarching objective for the world to strive for. This book marks the 20th anniversary of the report's publication.

Our Common Future, also known as the 'Brutland Report', provides the basis for the collection of essays which make up this book. They are mainly written by environmental lawyers in Northern Europe. All of the authors are experts in environmental and sustainable development law.

This book charts the influence of sustainable development upon international law. It sheds light on the legal content, and nature, of sustainable development by looking at its meaning and application in terms of objectives, principles and processes.

In Part I of the book, Hans Christian Bugge outlines the Brutland Report's message in terms of sustainable development. The report's coverage of the effects of population growth, rising energy consumption and increased food requirements sets the scene for the rest of the book. An analysis of the effects of industrial output is then presented, in relation to the ecological stability of the ecosystem. The report's proposals for institutional and legal change are looked at retrospectively. What follows is a series of broader theoretical discussions of the concept and its legal meaning by Gerd Winter, Staffan Westerlund and Felix Ekardt. Concepts such as the three pillars of sustainability, future-proof politics and the non-sustainability of the western world are tackled in a scholarly manner, enabling the reader to draw their own conclusions from the evidence placed before them.

Part II examines the wider impact of sustainable development on international law in general. Marie-Claire Cordonier Segger uses specific examples to trace the development of the concept over the past 20 years. Alan Boyle, Nico Schrijver and Tuula Kolari give their analysis relative to their particular field of interest. The writers look at the effects of, and politics surrounding, the 1992 United Nations Conference on the Environment and Development, the 1997 United Nations General Assembly Special Session on Sustainable Development and the 2002 World Summit for Sustainable Development.

Coverage is given to the legal status of sustainable development. Principles are considered in contrast to purposes, leading to the development of a customary principle of international law. This is complemented by a discussion of the Bio-safety Protocol, the FAO Seed Treaty and the Kyoto Protocol, followed by a debate about whether states are bound by a principle of sustainable development.

The process of making principles is touched on, followed by discussions on the sustainable use of natural resources, and principles of equity and the eradication of poverty. An interesting exploration of the precautionary principle is made, with regard to natural resources, human health and ecosystems.

An exploration of the function of sustainable development in international trade and investment law is carried out in Part III by Markus Gehring, Asa Romson, Nathalie Bernasconi-Osterwalder, Katinka Jesse and Marie-Jose van der Heiden. The use of world

trade law as an instrument for sustainable development is tackled with coverage of recent disputes linked to sustainable development issues and the growing importance of international economic dispute settlement. This discussion is made in the context of transparency and public participation in dispute settlement, and the settlement procedures at the World Trade Organisation. The hidden environmental impacts are also assessed, with reference to the powerful banking systems and multinational enterprises.

Part IV deals with sustainable development and its function within European law. A broad overview is provided by Ludwig Kramer, with specific chapters on waste policy from Nicholas de Sadeleer, public procurement from Ari Ekroos, and bio-energy from Catherine Banet. The examination of primary and secondary EC legislation takes place, followed by discussions on policy relating to fisheries, energy, regional development and the environment.

The analysis continues in Part V with Angel Manuel Moreno and Eva Westerlund looking at two examples of the operational aspects of sustainable development in land use planning in Spain, and criminal law. The operational principles developed from the Spanish experience provide a useful guideline to any practitioner involved in sustainable planning development. Emphasis is placed on noise pollution, landscape protection, spatial planning, building regulations and nature conservation issues. The use of criminal law for the protection of the environment is looked at in relation to the precautionary principle, with examples taken from the Swedish Environmental Code. The interpretation of existing rules using sustainable development principles is explored, leading to a discussion of how new rules can be made using sustainable development principles.

In Part VI, Massimiliano Montini, Christina Voight and Kars de Graaf deal with sustainable development in relation to climate change and energy regulations, at both national and international levels. The content and effect of the Kyoto Protocol and subsequent documents is discussed, followed by a comparison of the interplay of inter-generational and intra-generational equity on climate change issues. The Dutch experience with wind energy in the North Sea is reviewed, outlining how the Dutch overcame the difficulties of applying sustainable policy into legislation.

There is no single theory as to what constitutes sustainable development. This book contains diverse opinions as to the level of progress and implementation in the field. However, the importance and relevance of the impact of sustainable development on national and international law is a theme running through all the articles. The common viewpoint, which is expressed within all the articles, is the recognition of the inextricable link between the human world and the natural world, and the need to balance the interests of mankind within a rigid framework to limit, or reverse, the damage to the ecosystem.

Any lawyer working within the area of sustainable development is tasked with the protection of the environment and the preservation of the ecosystem for future generations. The writings within this text provide differing viewpoints, which assist any lawyer to build strong arguments and counterarguments when involved in litigation. This book can broaden the reader's knowledge by providing an opportunity to juxtapose alternative viewpoints on the same sustainable development issues. The balancing, on one hand, of economic development is weighed against the cost to the environment and ecosystem and opportunities of future generations.

This text provides excellent coverage of the law in relation to sustainable development issues, and demonstrates how sustainable development does not only affect environmental law, but also crosses over into many other legal areas including torts, the WTO, banking and planning legislation.

Michael Browne

**John Shijian Mo, *International Commercial Law* (4th ed), Sydney, LexisNexis Butterworths, 2008, ISBN 9780409324570**

International commercial law, also known as international trade law, has become an established field of study. This can be demonstrated by the popularity of the textbook *Schnithoff's Export Trade: The Law and Practice of International Trade* (2007), now in its eleventh edition. There are also numerous law journals and other textbooks on the subject. *International Commercial Law* is a particularly commendable textbook as it provides an easy-to-read analysis of complex international issues in a practical manner, and includes many recent legal developments. Whilst the text examines how Australian law is impacted by international commercial law it also provides a wider perspective by including cases from other jurisdictions.

Since the first edition, this text has become longer, but now has a better structure and has been fully updated. As would be expected in a textbook that is now over 900 pages long, there is an updated preface and introduction, table of cases and table of statutes, as well as an index. Whilst the chapter headings have not been altered since the previous edition, the chapters are clearer and more comprehensive.

Chapters 1 and 2 cover the international sale of goods under domestic law and the United Nations Convention on Contracts for the International Sale of Goods (CISG), respectively. The discussion of the CISG has been updated to incorporate Australian case law handed down since the previous edition.

Chapter 3 covers contracts relating to intellectual property and other international commercial activities. The discussion of major issues in franchising arrangements includes recent developments, such as the 2007 Chinese Administrative Measures on the Disclosure of Information in Franchise Operations. The section on e-commerce similarly includes cases which have arisen after publication of the last edition. It also lists recent activities of the United Nations Commission on International Trade Law (UNCITRAL) and discusses the United Nations Convention on the Use of Electronic Communications in International Contracts.

Chapter 4, on contracts for carriage by sea, air and land, has also been updated to include new material. It is followed by a chapter on the means of payment in international trade which considers the 2007 Revision of the Uniform Customs and Practice for Documentary Credits.

Similarly to the previous edition, Chapter 6 introduces international banking and financing. The discussion on marine insurance in Chapter 7 still covers aviation insurance and international trade, but has been expanded. Chapter 9, covering the World Trade Organisation (WTO), and Chapter 10, considering regional economic cooperation, have also been updated.

Whilst the text has been completely revised, the discussion of WTO conflict of laws in Chapter 11 sets this edition apart. John Mo has added 38 pages to the beginning of the chapter to explain the importance of conflicting rules in international commerce as well as relevant terms and concepts. This allows students to have a broader and more composite understanding of how international laws can conflict, before attempting to understand more complex or inter-related legal issues. Finally, similar to the previous edition, the last chapter, Chapter 12, discusses alternative means of settling international commercial disputes.

International commercial law is a field of increasing importance. This textbook provides a comprehensive yet concise discussion of international matters and is arguably the most updated text available. It is also worth noting that the 1995 student companion to this textbook, titled *Butterworths Student Companions: International Commercial Law*, still provides a valuable quick reference tool for students. These books complement each other and are excellent for students, practitioners and academics of law or business alike.

Kara Churchward

**Robin Burnett and Vivienne Bath, *Law of International Business in Australasia*, Sydney, The Federation Press, 2009, ISBN 9781862877245**

This text is the successor to the third edition of Robin Burnett's *Law of International Business Transactions*, published in 2004. Vivienne Bath has now joined Burnett as co-author. Both authors have extensive expertise in the field of international trade law, having taught and worked in the field for many years. The authors' wealth of knowledge results in an up-to-date, comprehensive treatise that addresses the complex legal issues facing businesses that engage in international trade. Burnett and Bath explore these issues from a distinctly Australasian and commercial perspective. As a result, the book is a valuable text on how to conduct international trade in the Australasian context.

Part one of the book deals with the international sale of goods, and Chapter 1 begins at the logical starting place: how to conclude an international contract for sale of goods. Australia and New Zealand have both implemented the Convention on Contracts for the International Sale of Goods (CISG). The first half of the chapter discusses the CISG regime and the way that it interacts with domestic Australasian law. The focus is on the formation and performance of international sales contracts, including remedies and the rights and duties of the parties. The second half of the chapter is a comprehensive explanation of Incoterms.

Chapter 2 discusses the international carriage of goods. The authors explain the international regimes relating to carriage of goods by sea, multi-modal transport and carriage of goods by air. They then discuss the use and types of freight documents and the relevant legislation. International conventions such as the Hague-Visby Rules, the Hamburg Rules and the Rotterdam Rules have effect in Australasia and are discussed in detail. The highlight of this chapter is the discussion of the provisions and possible adoption of the United Nations Commission on International Trade Law (UNCITRAL) Draft Convention on the Carriage of Goods Wholly or Partly by Sea. The chapter concludes with a discussion of marine insurance.

Chapter 3 addresses a very important element of international trade: how to pay for the goods. This chapter focuses on the various services that banks offer to facilitate international transactions. The first section discusses the methods of financing a contract for sale, such as electronic funds transfer and bills of exchange. The next section is a comprehensive discussion of the international regime governing the use of documentary letters of credit, including the changes in 2007 because of the adoption of the UCP 600. The last part of this chapter outlines the duties of banks in relation to documents.

In Part two of the book, the focus shifts to international and domestic regimes that affect the way Australasian businesses conduct international trade. Chapter 4 discusses international regimes such as the World Trade Organisation (WTO), General Agreement on Tariffs and Trade (GATT) and bilateral trade agreements. It also covers customs regimes, anti-dumping legislation, non-tariff barriers and government assistance schemes in Australasia. In Chapter 5, the authors examine international agreements that deal with trade in services, the Australasian foreign direct investment regime and international competition policy. The final section of Chapter 5 is a comprehensive discussion of the international treaties relating to intellectual property.

Part three covers issues that affect Australasian businesses when operating overseas. Chapter 6 outlines contractual relationships used in international trade, such as agency, distribution agreements, licensing agreements and franchising. The authors then discuss the structures

used by companies wanting to establish a physical presence in a host country. Chapter 6 also discusses Australasian legislation that implements the international conventions dealing with bribery and corruption.

The final chapter of the book focuses on dispute resolution. It discusses investor-state disputes, which are generally resolved through arbitration under the International Centre for Settlement of Investment Disputes (ICSID) Convention, and the legal framework for commercial arbitration in Australasia, where various international conventions are in force. The high point of this chapter is the valuable discussion of the drafting of dispute resolution and arbitration clauses in international contracts.

Burnett and Bath have identified the issues facing international traders, reviewed the multitude of options available to deal with these issues and carefully outlined the risks and benefits involved. This book is highly readable, well structured and scrupulously footnoted. It is no dry treatise on the legal intricacies of international trade. On the contrary, the book is full of practical advice and is a valuable resource for practitioners and businesses alike.

Claire Vinten