EXCEPTION CLAUSES IN INTERNATIONAL INVESTMENT AGREEMENTS AS A TOOL FOR APPROPRIATELY BALANCING THE RIGHT TO REGULATE WITH INVESTMENT PROTECTION

Robert Brew*

Abstract

Finding an appropriate equilibrium between investment protection and states' regulatory autonomy has long been a vexing problem in international investment law. In light of genuine problems of uncertainty in international investment arbitration and growing challenges to the legitimacy of international investment agreements (IIAs), stakeholders have a mutual interest in ensuring that IIAs not only fulfil their purpose of protecting foreign investors to the greatest extent possible, but also better clarify and secure states' right to regulate for legitimate objectives, even where this may inhibit investment protection. Appropriately designed exception clauses allow these aims to be achieved simultaneously. This paper develops a model exception clause under which states may define their policy objectives and the extent to which they desire to pursue them, and which precludes tribunals from subjectively assessing these objectives' importance during their analysis. The clause permits states to contradict their substantive IIA obligations while pursuing a particular objective to the desired extent, provided that they act in the manner which is least inconsistent with these obligations. A 'chapeau' requires that states regulate with no motive of restricting foreign investment as a goal in itself. The clause is of general application and subject to full tribunal review.

I. Introduction

Where the ideal balance lies between the interests of investment protection and states' right to regulate has long been an intractable problem in international investment law. Investors' ability under many international

* Dissertation submitted in accordance with the requirements of the Bachelor of Laws (Honours) degree at the University of Canterbury. This paper was the prize-winning essay for the Canterbury Law Review prize for the best piece of legal writing by an undergraduate student at the University of Canterbury. I would like to express my sincere gratitude to Dr Christian Riffel, who supervised my dissertation and provided insightful and immensely helpful comments, ideas and feedback throughout the entire process of planning, drafting and writing the paper.

investment agreements (IIAs)[1] to directly challenge states' regulatory measures, through investor-state dispute settlement (ISDS) mechanisms, enables them to credibly enforce their rights under international investment law. It also, however, undermines states' right to regulate in the public interest, a fundamental facet of state sovereignty. The uncertainty and inconsistency characterising international investment jurisprudence have exacerbated states' concerns about the international investment regime. IIAs appear to have lost their lustre, with 2017 marking the first year in which effective terminations outnumbered new conclusions of IIAs.[2] Certain states have voiced their displeasure by withdrawing from IIAs or withdrawing their consent to ISDS,[3] while others have inserted provisions in IIAs which assert their right to regulate. One approach is to include exception clauses within IIAs, often taking inspiration from the exception clauses of the General Agreement on Tariffs and Trade (GATT)[4] and the General Agreement on Trade in Services (GATS).[5]

The function of exception clauses depends on their design and interpretation, but this paper conceives 'exception clauses' as clauses whose successful invocation precludes a public policy measure from constituting a breach of a state's IIA obligations.

Much of the literature on exception clauses in IIAs has concerned their interpretation by tribunals, particularly in the context of a series of cases[6] relating to Argentina's invocation of Article XI of the United States-

1 When this paper refers to 'IIAs', this comprises both bilateral investment treaties and other treaties with investment provisions, such as free trade agreements with an investment chapter.

2 United Nations Conference on Trade and Development *World Investment Report 2018: Investment and New Industrial Policies* UNCDAT/WIR/2018 at 88.

3 Numerous countries, including South Africa, Indonesia and Ecuador, have terminated various of their IIAs, while Bolivia, Ecuador and Venezuela have denounced the ICSID Convention. See Tania Voon and Andrew D Mitchell "Denunciation, Termination and Survival: The Interplay of Treaty Law and International Investment Law" (2016) 31 ICSID Review 413 at 416–417 and 424–426.

4 General Agreement on Tariffs and Trade 1994 1867 UNTS 190 (signed 15 April 1994, entered into force 1 January 1995) [GATT], art XX.

5 General Agreement on Trade in Services 1869 UNTS 183 (signed 15 April 1994, entered into force 1 January 1995) [GATS], art XIV.

6 *CMS Gas Transmission Co v Argentina (Award)* ICSID ARB/01/8, 12 May 2005 [*CMS Award*]; *CMS Gas Transmission Co v Argentina (Decision on Annulment)* ICSID ARB/01/8, 25 September 2007[*CMS Decision on Annulment*]; *LG&E Energy Corp v Argentina (Decision on Liability)* ICSID ARB/02/1, 3 October 2006 [*LG&E Decision on Liability*]; *Enron Corp v Argentina (Award)* ICSID ARB/01/3, 22 May 2007 [*Enron Award*]; *Enron Corp v Argentina (Decision on Annulment)* ICSID ARB/01/3, 30 July 2010 [*Enron Decision on Annulment*]; *Sempra Energy International v Argentina (Award)* ICSID ARB/02/16, 28 September 2007 [*Sempra Award*]; *Sempra Energy International v Argentina (Decision on Annulment)* ICSID ARB/02/16, 29 June 2010 [*Sempra Decision on Annulment*]; and *Continental Casualty Co v Argentina (Award)* ICSID ARB/03/9, 5 September 2008 [*Continental Casualty Award*].

Argentina bilateral investment treaty (BIT) (US-Argentina BIT).[7] This paper seeks, however, to avoid leaving interpretive discretion to tribunals, which are notorious for differing widely in their analyses. Instead, it examines how exception clauses may be specifically drafted so as to ensure an appropriate balance between states' right to regulate in the public interest with the protection of investors.

Part II considers the competing interests arising in relation to IIAs. It examines the rationales for protecting foreign investors under IIAs, before proceeding to examine how IIAs can threaten states' sovereign right to regulate in the public interest and discourage states from regulating towards legitimate ends. It identifies the uncertain parameters of the right to regulate under international investment law as well as some tribunals' tendency to weigh and balance non-investment policy objectives against the objective of investment protection as particular deficiencies of the 'right to regulate' approaches currently undertaken by tribunals. It seeks overall to ascertain the shared interest of all stakeholders under IIAs in preserving both investment protection and states' right to regulate to the greatest extent possible, and the role which exception clauses can play in this respect.

Part III examines various elements of exception clauses whose formulation affects the ultimate balance between investment protection and states' right to regulate in an IIA, with a view to combining this Part's recommendations regarding each separate characteristic into a model IIA exception clause. It first assesses the list of permissible policy objectives which measures may pursue in order to be justified under the clause, considering whether this list should be non-exhaustive and emphasising that any listed objectives should be specifically defined so as to reduce tribunals' leeway in interpreting their meaning. It then examines the 'nexus' requirement, which governs the required relationship between a measure and a permissible objective in order for the measure to fall within the clause's coverage. In doing so, it seeks to define different nexus formulations so as to determine which should be used in an IIA exception clause. It then considers whether the clause should include 'self-judging' language, after examining the effect which the use of such language may have on tribunals' possible standard of review of an exception clause. It then questions whether IIA exception clauses should contain a 'chapeau' imposing conditions on their use, focusing particularly on the chapeau's role in identifying ulterior protectionist motives underlying a measure. Finally, it considers whether the clause should cover all, or only some, obligations under an IIA. Particularly important considerations throughout this analysis are the need to ensure certainty in the clause's application and to preclude tribunals from weighing public policy interests against the interest of investment protection.

7 Treaty between the United States of America and the Argentine Republic concerning the Reciprocal Encouragement and Protection of Investment 31 ILM 124 (entered into force 20 October 1994) [US-Argentina BIT].

Part IV constructs a model IIA exception clause on the basis of Part III's findings, before concluding the paper.

II. The Competing Interests under IIAs

A. Investment Protection as IIAs' Basic Purpose

1 The benefits of IIAs for investors

Foreign investors occupy an inherently vulnerable position. After placing considerable resources into a long-term project, they cannot usually disinvest with ease.[8] Still, investors are insufficiently protected without an applicable IIA. Jurisdictional and immunity-related issues will usually preclude challenges to host state actions in investors' home courts.[9] Guarantees under host state law are unstable; policy changes, often following changes in government, can dramatically alter investors' positions.[10] Host state courts may be biased.[11]

Protections under customary international law include fair and equitable treatment (FET)[12] and a prohibition of expropriation without compensation.[13] These are not, however, accompanied by any adequate mechanism for enforcing investors' rights.[14] Investors must rely on diplomatic protection, whereby their home state pursues their claim in its own name, but this occurs entirely at the home state's discretion.[15]

This limited protection places considerable risks on investors, who bear the costs of state actions harming their investment(s).[16] IIAs reallocate these risks and costs towards host states.[17] IIAs usually impose various obligations

8 Rudolf Dolzer and Christoph Schreuer *Principles of International Investment Law* (2nd ed, Oxford University Press, Oxford, 2012) at 81–82; and Anne van Aaken "International Investment Law Between Commitment and Flexibility: A Contract Theory Analysis" (2009) 12 JIEL 507 at 520.

9 Dominic N Dagbanja "The Limitation on Sovereign Regulatory Autonomy and Internationalization of Investment Protection by Treaty: An African Perspective" (2016) 60 J Afr L 56 at 66.

10 Dolzer and Schreuer, above n 8, at 82.

11 Dagbanja, above n 9, at 65.

12 *Merrill and Ring Forestry LP v Canada (Award)* ICSID UNCT/07/1, 31 March 2010 at [210].

13 Surya P Subedi "International Investment Law" in Malcolm D Evans (ed) *International Law* (4th ed, Oxford University Press, Oxford, 2014) 727 at 740–741.

14 Jeswald W Salacuse "The Treatification of International Investment Law" (2007) 13 Law and Business Review of the Americas 155 at 155.

15 *Barcelona Traction, Light and Power Co, Ltd (Belgium v Spain) (Second Phase)* [1970] ICJ Rep 3 at [79]. See also Dolzer and Schreuer, above n 8, at 229.

16 William W Burke-White and Andreas von Staden "Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties" (2008) 48 Va J Intl L 307 at 401–402.

17 Burke-White and von Staden, above n 16, at 401–402.

vis-à-vis foreign investors upon state parties, relating, *inter alia*, to FET, discrimination and expropriation. Most IIAs empower investors to make direct claims, through ISDS mechanisms, against states for breaches of such obligations.[18] This enables investors to enforce their rights far more reliably than would otherwise be possible.

2 The benefits of IIAs for states

Many states seemingly perceive IIA membership as beneficial, considering the large number and widespread distribution of IIAs.[19] Some states will wish to ensure the protection of their own nationals investing elsewhere.[20] Predominantly capital-importing states apparently seek to encourage Foreign Direct Investment (FDI) inflows. The preamble to the world's first BIT addressed its likelihood to "promote investment", thereby generating greater prosperity in the state parties.[21] Some IIAs cite more specific benefits like "sustainable development".[22]

Various studies indicate that increased FDI inflows have a positive impact upon economic growth,[23] though this may vary depending on local conditions.[24] Regardless, FDI is "the largest external source of finance for developing economies", as of 2017.[25] Whether entering into IIAs increases FDI inflows at all is, however, uncertain. It is difficult to isolate an IIA's

18 See, for example, North American Free Trade Agreement [1994] CTS 2 (entered into force 1 January 1994), art 1120; and Comprehensive Economic and Agreement between Canada and the European Union (signed 30 October 2016, entered into force September 21 2017) [CETA], art 8.23.

19 There existed 3,322 IIAs as of 2017. United Nations Conference on Trade and Development, above n 2, at 88.

20 Kate P Supnik "Making Amends: Amending the ICSID Convention to Reconcile Competing Interests in International Investment Law" (2009) 59 Duke LJ 343 at 354.

21 Treaty between the Federal Republic of Germany and Pakistan for the Promotion and Protection of Investments (signed 25 November 1959, entered into force 28 April 1962), preamble.

22 Agreement Between Canada and Mongolia for the Promotion and Protection of Investments (signed 8 September 2016, entered into force 24 February 2017), preamble.

23 See, for example, Henrik Hansen and John Rand *On the causal links between FDI and growth in developing countries* (United Nations University World Institute for Development Economics Research, No 2005/31, 2005) at 15; Abdalla Sirag, Samira SidAhmed and Hamisu Sadi Ali "Financial development, FDI and economic growth: evidence from Sudan" (2018) 45 International Journal of Social Economics 1236 at 1246; Issouf Soumaré "Does FDI improve economic development in North African countries?" (2015) 47 Applied Economics 5510 at 5532; and Jelena Tast "The Role of FDI in the Economic Development of Transition Countries" (2014) 2(2) Eurasian Journal of Economics and Finance 34 at 37.

24 Chien-Chiang Lee and Chun-Ping Chang "FDI, Financial Development, and Economic Growth: International Evidence" (2009) 12 Journal of Applied Economics 249 at 267.

25 United Nations Conference on Trade and Development, above n 2, at x.

effect from other variables.[26] A 2003 World Bank study ascertained "little evidence that BITs have stimulated additional investment" generally, finding that countries with weaker institutions and property protection had benefited least from acceding to BITs, despite most obviously needing "a BIT to signal the quality of their property rights".[27] However, American BITs, which offer particularly strong investment protection, have been found to "most likely" promote American FDI outflows.[28] Neumayer and Spess found that "[d]eveloping countries that sign more BITs with developed countries receive more FDI inflows".[29] Another scholar concluded, however, that "BITs have little or no impact on investment decisions".[30]

While IIAs certainly benefit foreign investors, the benefits for predominantly capital-importing states are uncertain; increased FDI inflows probably promote economic growth, but perhaps not universally, while IIA membership may well, but does not necessarily or universally, increase FDI inflows. Nevertheless, the purpose of IIAs is difficult to discern if it is not to ensure the protection of foreign investors (for whatever ulterior motive). IIAs must therefore protect foreign investors to the greatest extent possible. States should be interested in ensuring this, because investors will likely seek high returns where they perceive their protection to be low.[31] Nevertheless, investor protection should be tempered by the need to better preserve states' right to regulate for legitimate objectives.

B. The Right to Regulate in International Investment Law

1 International investment law and regulatory autonomy: an uneasy relationship

IIAs, particularly those providing for ISDS, inherently interfere with states' autonomy, in imposing obligations upon states in the exercise of their sovereign functions. Through ISDS, investors have challenged various

26 Kenneth J Vandevelde "Investment Liberalization and Economic Development: The Role of Bilateral Investment Treaties" (1998) 36 The Columbia Journal of Transnational Law 501 at 524–525.

27 Mary Hallward-Driemeier *Do Bilateral Investment Treaties Attract Foreign Direct Investment? Only a Bit … and They Could Bite* (World Bank, Policy Research Working Paper 3121, August 2003) at 22–23.

28 Jeswald W Salacuse and Nicholas P Sullivan "Do BITs Really Work: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain" (2005) 46 Harv Intl LJ 67 at 104–111; see also Yoram Z Haftel "Ratification counts: US investment treaties and FDI flows into developing countries" (2010) 17 Review of International Political Economy 348 at 368–369.

29 Eric Neumayer and Laura Spess "Do bilateral investment treaties increase foreign direct investment to developing countries?" (2005) 33 World Development 1567 at 1582.

30 Jason Webb Yackee "Bilateral Investment Treaties, Credible Commitment, and the Rule of (International) Law: Do BITs Promote Foreign Direct Investment?" (2008) 42 L & Socy Rev 805 at 828.

31 Burke-White and von Staden, above n 16, at 401–402.

ostensibly public policy-based measures, including the prohibition of a chemical deemed to harm the environment,[32] a nuclear power phase-out[33] and plain-packaging legislation for tobacco products.[34] States' right to regulate is generally considered to be fundamental to state sovereignty;[35] states will likely perceive any interference with it as highly undesirable. Moreover, investors' ability to challenge legitimate regulatory measures can generate "regulatory chill", whereby states refrain from regulating adequately to achieve policy objectives in fear of otherwise being sued by investors.[36] Although under one-third of ISDS outcomes have favoured investors,[37] investor-state arbitration is very costly, even for victorious states.[38] States thus fear being subjected to it at all.

The characteristics of ISDS are also controversial. Van Harten likens ISDS to a form of judicial review, in empowering individuals to challenge states' sovereign acts, which however lacks safeguards for arbitrators' independence such as secure tenure, objective appointment methods and limits on remuneration.[39] Individual arbitrators are appointed by the parties,[40] which renders them keenly aware of their reputation with investors and states when making decisions.[41] Van Harten and Loughlin suggest that tribunals may have an "institutional bias" in investors' favour as their commercial interest is

32 *Methanex Corp v United States (Final Award of the Tribunal on Jurisdiction and Merits)* (2005) 44 ILM 1345 [*Methanex v United States*].

33 Nathalie Bernasconi-Osterwalder "*Vattenfall v Germany*" (May 2012) <iisd.org>.

34 *Philip Morris Asia Ltd v Australia (Award on Jurisdiction and Admissibility)* PCA 2012-12, 17 December 2015.

35 See, for example, Vera Korzun "The right to regulate in investor-state arbitration: slicing and dicing regulatory carve-outs" (2017) 50 Vanderbilt Journal of Transnational Law 355 at 382; Suzanne A Spears "The Quest for Policy Space in a New Generation of International Investment Agreements" (2010) 13 J Intl Econ L 1037 at 1038; and Srikar Mysore and Aditya Vora "Tussle for Policy Space in International Investment Norm Setting: the Search for a Middle Path?" (2016) 7 Jindal Global Law Review 135 at 137.

36 Bruno Simma "Foreign Investment Arbitration: A Place for Human Rights?" (2011) 60 The International and Comparative Law Quarterly 573 at 580.

37 Investment Policy Hub "Investment Dispute Settlement Navigator" (31 July 2018) <investmentpolicyhub.unctad.org>.

38 A study of 138 ICSID cases, in which the claimant partially or fully succeeded in only 39, found that the respondent's average and median costs were approximately USD 4,950,000 and USD 3,650,000, respectively. See Jeffery P Commission "How Much Does an ICSID Arbitration Cost? A Snapshot of the Last Five Years" (29 February 2016) Kluwer Arbitration Blog <arbitrationblog.kluwerarbitration.com>.

39 Gus Van Harten "Arbitrator Behaviour in Asymmetrical Adjudication: An Empirical Study of Investment Treaty Arbitration" (2012) 50 Osgoode Hall LJ 211 at 213 and 217–218.

40 Convention on the Settlement of Investment Disputes between States and Nationals of other States 575 UNTS 159 (signed 18 March 1965, entered into force 14 October 1966) [ICSID Convention], art 37; and *UNCITRAL Arbitration Rules* UN Doc A/RES/31/98 (1976), arts 6–7.

41 Korzun, above n 35, at 371.

for more claims to be made.[42] Some studies tentatively suggest that tribunals are biased towards investors,[43] while others find no such bias.[44] Nevertheless, one can question the appropriateness of bodies with these characteristics adjudicating states' sovereign acts.

2 Deficiencies of current 'right to regulate' approaches

Tribunals often account for measures' public policy objectives when analysing whether a state has breached its obligation(s) under international investment law. However, significant uncertainty results from the inconsistent tribunal jurisprudence in this respect. Moreover, tribunals often weigh a measure's investment-restrictiveness against the importance of a given policy objective, despite tribunals being inappropriate institutions for usurping matters of policy prioritisation from states.

(a) The uncertainty problem

Under FET, the most frequently invoked obligation,[45] tribunals have stated that the existence of a breach must be determined "in light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders".[46] However, tribunals may afford such considerations limited weight in practice. *Eiser Infrastructure Ltd v Spain* concerned Spain's replacement of its regulatory framework providing subsidies to renewable energy investments, in an attempt to reduce its tariff deficit.[47] The tribunal acknowledged Spain's tariff deficit as a "legitimate public policy problem" and "[did] not question the appropriateness of Spanish authorities adopting reasonable measures to address the situation",[48] but because "fundamental" changes to the regulatory

42 Gus Van Harten and Martin Loughlin "Investment Treaty Arbitration as a Species of Global Administrative Law" (2006) 17 EJIL 121 at 148.

43 See, for example, Van Harten, above n 39, at 238–239.

44 See, for example, Susan D Franck and Lindsey E Wylie "Predicting outcomes in investment treaty arbitration" (2015) 65 Duke LJ 494 at 520–526; and Peter Nunnenkamp "Biased Arbitrators and Tribunal Decisions against Developing Countries: Stylized Facts on Investor-State Dispute Settlement" (2017) 29 Journal of International Development 851 at 853–854.

45 Mysore and Vora, above n 35, at 145.

46 *SD Myers Inc v Canada (Partial Award)* Bryan Schwartz, Edward Chiasson, J Martin Hunter, 13 November 2000 [*SD Myers v Canada*] at [263]; and *Mesa Power v Canada (Award)* PCA 2012-17, 24 March 2016 at [493].

47 *Eiser Infrastructure Ltd v Spain (Award)* ICSID ARB/13/36, 4 May 2017 at [111]–[113], [117]–[119] and [146]–[151]. A "tariff deficit", according to the tribunal, is "the financial gap between the costs of subsidies paid to renewable energy producers and revenues derived from energy sales to consumers", at [124]. It should not be confused with 'tariffs' in relation to trade.

48 At [371].

regime had not accounted for investors' reliance on the former regime,[49] it found a breach of FET.[50] The circumstances in which measures pursuing policy objectives will breach the FET standard, even where a tribunal acknowledges their legitimacy, are therefore ambiguous. Some tribunals approach FET by 'weighing and balancing' the legitimate regulatory objective with the investor's interests, but this creates other problems and generates uncertainty anyway, as is shortly discussed.[51]

States' right to regulate regarding indirect expropriation is similarly blurry. Under the customary 'police powers' doctrine, measures affecting investors' property interests do not constitute indirect expropriations where they "fall within the ambit of the state's general regulatory or administrative powers, pursue a legitimate purpose, are aimed at the general welfare, and are non-discriminatory".[52] Although some tribunals have stipulated that states need not compensate the investor in such circumstances,[53] others have held that a measure's public purpose does not preclude any requirement to pay compensation.[54]

States cannot therefore know which public policy regulations may generate liability and/or an obligation to pay compensation, which could dissuade them from taking even necessary regulatory measures. This uncertainty also harms investors, who cannot confidently know their position when challenging a public policy measure.

Some reasons for inconsistent tribunal decisions are procedural, such as the lack of formal precedent[55] or of any true appeals mechanisms[56] in

49 At [363].

50 At [458].

51 See discussion below at IIB2(b).

52 Andrew D Mitchell and Caroline Henckels "Variations on a Theme: Comparing the Concept of "Necessity" in International Investment Law and WTO Law" (2013) 14 Chicago Journal of International Law 93 at 122–123.

53 See, for example, *Técnicas Medioambientales Tecmed SA v Mexico (Award)* ICSID ARB(AF)/00/2, 29 May 2003 [*Tecmed Award*] at [119]; *Marvin Roy Feldman Karpa v Mexico (Award)* ICSID ARB(AF)/99/1, 16 December 2002 [*Feldman Award*] at [103]; and *Ronald S Lauder v Czech Republic (Final Award)* (3 September 2001) Lloyd Cutler, Bohuslav Klein and Robert Briner, Italaw <www.italaw.com> at [198]; and *Methanex v United States*, above n 32, at Part IV, Chapter D, [7].

54 See, for example, *Compañía del Desarrollo de Santa Elena SA v Costa Rica (Final Award)* ICSID ARB/96/1, 17 February 2000 at [72].

55 Suzanne A Spears "The Quest for Policy Space in a New Generation of International Investment Agreements" (2010) 13 J Intl Econ L 1037 at 1040.

56 Alec Stone Sweet "Investor-State Arbitration: Proportionality's New Frontier" (2010) 4 Law & Ethics of Human Rights 46 at 66. See also Susan D Franck "The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law through Inconsistent Decisions" (2005) 73 Fordham L Rev 1521 at 1547 and 1555. For the grounds for annulment in ICSID arbitration, see ICSID Convention, above n 42, art 52(1). For the grounds of non-recognition of awards in most non-ICSID arbitration, see Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) 330 UNTS 38 (signed 10 June 1958, entered into force 7 July 1959), art V.

international investment arbitration, and cannot be fixed by IIA design. Another key reason, however, is the wide discretion afforded to tribunals by the broad wording of IIA provisions.[57]

Exception clauses can themselves exacerbate this uncertainty. For example, in ascertaining the meaning of "necessary" under Article XI of the US-Argentina BIT, the *CMS Gas Transmission Co v Argentina* (*CMS*), *Sempra Energy International v Argentina* (*Sempra*) and *Enron Corp v Argentina* (*Enron*) tribunals took guidance from the conditions of the "necessity" defence under customary international law,[58] while the *LG&E Energy Corp v Argentina* (*LG&E*) and *Continental Casualty Co v Argentina* (*Continental*) tribunals, as well as the *CMS* and *Sempra* annulment committees, considered that "necessity" under Article XI had a different content than the stringent customary defence.[59] Reading the requirements of the customary necessity defence into a treaty exception dramatically reduces a state's chance of successfully invoking an exception clause, as was reflected in the outcome of the cases.[60] Moreover, some tribunals have stated that exception clauses in IIAs should be interpreted "restrictively",[61] or "narrowly",[62] which could limit any improvements in states' right to regulate. An exception clause should thus be worded sufficiently clearly to remove tribunals' interpretive leeway.

This paper's recommended model of exception clause must therefore achieve greater certainty regarding the question of whether a given measure adopted for a legitimate public purpose, despite its investment-restrictive nature, will generate liability. Otherwise, states may decline to regulate where necessary to achieve a public good, while investors may simultaneously feel insufficiently protected to justify making a particular investment.

(b) The proportionality problem

Further undermining states' regulatory autonomy is the fact that tribunals frequently adopt an approach of weighing and balancing non-investment

57 Van Aaken, above n 8, at 527–528.

58 See *CMS Award*, above n 6, at [353]–[364]; *Sempra Award*, above n 6, at [376]; and *Enron Award*, above n 6, at [334].

59 See *LG&E Decision on Liability*, above n 6, at [245]; *Continental Casualty Award*, above n 6, at [192]; *CMS Decision on Annulment*, above n 6, at [129]–[134]; and *Sempra Decision on Annulment*, above n 6, at [111]–[118].

60 See *CMS Award*, above n 6, at [331]. While the *CMS* tribunal did not explicitly state that Article XI did not apply, it took the view "that Article XI was to be interpreted in the light of the customary international law concerning the state of necessity," and having rejected the application of the customary standard, it also implicitly rejected Argentina's Article XI defence. See *CMS Decision on Annulment* at [123]–[124]. See also *Sempra Award*, above n 6, at [391]; and *Enron Award*, above n 6, at [342].

61 *Enron Award*, above n 6, at [337]; and *Sempra Award*, above n 6, at [373].

62 *Canfor Corp v United States and Terminal Forest Products Ltd v United States (Decision on Preliminary Question)* (6 June 2006) Armand de Mestral, Davis Robinson and Albert Jan van den Berg, Italaw <www.italaw.com> at [187].

interests against the interest of investment protection, employing a so-called "proportionality *stricto sensu*" analysis. This entails a "true weighing and balancing of competing objectives," and involves the principle that "[t]he more intense the restriction of a particular interest, the more important the justification for the countervailing objective needs to be".[63] Proportionality *stricto sensu* is the final stage of a broader "proportionality" test, and follows a "suitability" analysis, where a measure's capability of achieving a policy objective is assessed, which is itself followed by a "necessity" stage, where the method used to achieve that objective is compared to different "suitable methods" of achieving that objective, in order to ensure that the means interfering least with a competing objective was adopted.[64] Some formulations also include a first step of assessing an objective's legitimacy.[65] Tribunals have used proportionality *stricto sensu* analysis regarding FET and expropriation.

For example, the *Saluka Investments BV v Czech Republic* tribunal noted that in determining whether FET has been breached, it is necessary to weigh "the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate regulatory interests on the other".[66] The *Técnicas Medioambientales Tecmed SA v Mexico* tribunal stated that whether state measures are expropriatory depends upon whether they "are proportional to the public interest presumably protected thereby and to the protection legally granted to investments".[67] The implication of these kinds of approaches is that a tribunal could find a breach should it consider a public policy objective unimportant or should it perceive the burden imposed on an investor to outweigh a measure's benefits.[68]

Some may view a proportionality *stricto sensu* approach as one which fairly balances investment protection against the "public interest" in an investor-state dispute.[69] However, various considerations militate against its use by investment tribunals. Henckels identifies its potentially "far-reaching" nature, because "it requires adjudicators to ascribe normative value to the measure's pleaded objective and determine whether its importance outweighs the importance of non-interference with the protected right or interest at

63 Mads Andenas and Stefan Zleptnig "Proportionality: WTO Law: in Comparative Perspective" (2007) 42 Tex Intl L J 371 at 390.

64 Andenas and Zleptnig, above n 63, at 378–379.

65 Caroline Henckels "Indirect Expropriation and the Right to Regulate: Revisiting Proportionality Analysis and the Standard of Review in Investor-State Arbitration" (2012) 15 J Intl Econ Law 223 at 245.

66 *Saluka Investments BV v Czech Republic (Partial Award)* (17 March 2006) Arthur Watts, L Yves Fortier and Peter Behrens, Italaw <www.italaw.com> at [305]–[306].

67 *Tecmed Award*, above n 53, at [122].

68 Andrew D Mitchell, James Munro and Tania Voon "Importing WTO General Exceptions into International Investment Agreements: Proportionality, Myths and Risks" in Lisa E Sachs, Lise J Johnson and Jesse Coleman (eds) *Yearbook on International Investment Law & Policy 2017* (Oxford University Press, Oxford, 2019) at 11 and 15.

69 Stone Sweet, above n 56, at 63 and 76.

stake".[70] Riffel notes that for an international adjudicative body to apply "proportionality *stricto sensu* would amount to a de novo review of domestic prioritization decisions".[71] It would move the "assessment and weighting of relative values [away from] national legislatures", in Kurtz' view.[72] This may well undermine domestic democratic processes.[73] An important aspect of regulatory autonomy is a state's freedom to decide its own regulatory priorities, and a tribunal's assessment as to an objective's importance should therefore not be able to override the state's judgment in this respect.

These considerations are especially problematic given the nature of investment tribunals. Tribunals' remoteness from states' domestic constitutional regimes suggests their inability to undertake careful balancing tasks as adequately as domestic institutions.[74] Ortino notes that the "monothematic" character of IIAs, which "principally [focus] on affording protection to foreign investments", renders the tribunals adjudicating on them unable to properly balance investment protection against other policy objectives.[75] Arbitrators' predominantly private or commercial law backgrounds[76] can leave them unsuited to weighing up public policy considerations. Tribunals are quite evidently less well-situated than domestic authorities to determine national policy objectives.

Overall, to enable tribunals to weigh the importance of investment protection against states' other policy interests, despite being unsuited to this task, interferes unduly with states' regulatory autonomy. A good faith measure may pursue an objective which a state considers extremely important, but nonetheless be found to constitute a breach, simply following a tribunal's subjective assessment that this objective is insufficiently important to justify the measure's investment-restrictiveness. It also provides tribunals with substantial scope to take varying approaches (thus exacerbating the uncertainty problem). Any prospect for tribunals to employ a proportionality *stricto sensu* analysis must therefore be precluded in an exception clause.

70 Henckels, above n 65, at 237.

71 Christian Riffel "The Chapeau: Stringent Threshold or Good Faith Requirement" (2018) 45 LIEI 141 at 172.

72 Jürgen Kurtz "Adjudging the Exceptional at International Investment Law: Security, Public Order and Financial Crisis" (2010) 59 The International and Comparative Law Quarterly 325 at 366–367.

73 Eyal Benvenisti "Sovereigns and Trustees of Humanity: on the Accountability of States to Foreign Stakeholders" (2013) 107 AJIL 295 at 332.

74 Caroline E Foster "Respecting regulatory measures: Arbitral method and reasoning in the *Philip Morris v Uruguay* plain packaging case" (2017) 26 Review of European, Comparative & International Environmental Law 287 at 288; Benvenisti, above n 73, at 332.

75 Federico Ortino "Investment Treaties, Sustainable Development and Reasonableness Review: A Case Against Strict Proportionality Balancing" (2017) 30 LJIL 71 at 91.

76 Simma, above n 36, at 576–577.

C. The Balancing Role of Exception Clauses

The foregoing discussion illustrates how IIAs and ISDS can interfere with states' right to regulate and generate regulatory chill. Perhaps understandably, numerous states are disengaging from the international investment regime. 2017 was the first year in which more IIAs were terminated than concluded, signifying "a period of reflection on, and review of, international investment policies".[77]

Other states have sought to better secure their regulatory autonomy through IIA reform.[78] Methods include weakening states' substantive obligations,[79] entirely precluding an IIA's application vis-à-vis certain policy areas[80] and even excluding recourse to ISDS.[81] These methods uniformly reduce investment protection, enabling no nuance in deciding *when* investor protection should yield to a legitimate regulatory objective.

Exception clauses offer a more balanced approach, permitting states to regulate subject to conditions designed specifically to limit the circumstances in which investors will lose their protection. Exception clauses can encourage "a country to accept BIT obligations that it otherwise could not accept",[82] and may accordingly appeal even to investors and predominantly capital-exporting states as an avenue of reform, at least compared to their alternatives. This is important where IIAs' current deficiencies justify finding *some* method of increasing or at least clarifying states' right to regulate.

In summary, a balance must be achieved when designing IIA exception clauses. It would be lamentable if states' fear of arbitration prevented them from exercising their sovereign prerogative to adequately respond to public policy needs. However, IIAs must still protect foreign investors to the greatest extent possible, so as to fulfil their overall purpose. Therefore, states' measures which pursue a legitimate policy objective should not generate liability under an IIA, provided that conditions, imposed in order to minimise any interference with investors' rights, are satisfied. Exception clauses must also ensure more certainty regarding the interaction between the right to regulate and investment protection, particularly by restricting tribunals' interpretive discretion.

77 United Nations Commission on Trade and Development, above n 2, at 88.

78 Prabhash Ranjan and Pushkar Anand "The 2016 Model Indian Bilateral Investment Treaty: A Critical Deconstruction" (2017) 38 Northwest J Intl L & Bus 1 at 6–7.

79 See, for example, CETA, art 8.10, which excludes breaches of legitimate expectations from the definition of FET.

80 See, for example, Indian Model BIT 2016, art 2.4(ii); Treaty between the United States of America and the Republic of Turkey Concerning the Reciprocal Encouragement and Protection of Investments (signed 3 December 1985, entered into force 18 May 1990), art XI(2). See also Ranjan and Anand, above n 78, at 44–45.

81 Investment Cooperation and Facilitation Agreement between the Federative Republic of Brazil and the Republic of Malawi (signed 25 June 2015, not yet in force), art 13.

82 Kenneth J Vandevelde "Rebalancing through Exceptions" (2013) 17 Lewis & Clark Law Review 449 at 455.

III. Characteristics of Exception Clauses

A. Permissible Objectives

The range of objectives which may be pursued under an exception clause is important, setting the outer policy boundaries within which states' investment-restrictive measures may possibly be justified.

1 Using a non-exhaustive list

IIA exception clauses generally provide an exhaustive list of permissible objectives. Article 2.2 of the Agreement on Technical Barriers to Trade, although not an exception clause, takes a different approach:[83]

> Members shall ensure that technical regulations are not prepared, adopted or applied with a view to or with the effect of creating unnecessary obstacles to international trade. For this purpose, technical regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective, … Such legitimate objectives are, inter alia …

This article's use of the phrase "*inter alia*" renders its list of permissible objectives non-exhaustive.[84] Contemplating the ordinary definition of "legitimate", the World Trade Organization's (WTO) Appellate Body (AB) suggested that a non-listed "legitimate objective" would be one which "is lawful, justifiable, or proper" and that the "legitimacy" of an objective may be ascertained by reference to the listed objectives and/or "objectives recognized in the provisions of other covered agreements".[85]

This paper recommends allowing non-listed objectives to be permitted provided that they are "legitimate" according to specified criteria. Taking inspiration from the aforementioned ordinary definition of "legitimate", an objective would be "legitimate" where the state can establish that some benefit could reasonably be expected to derive from its fulfilment, and where the objective itself is not to breach any provision of the IIA. This latter requirement is crucial; the fulfilment of an objective of discriminating against foreign investors, for example, could benefit a state, but to allow such an objective to be characterised as "legitimate" would enable any IIA-inconsistent measure to be justified, thereby entirely undermining an IIA's purpose.

83 Agreement on Technical Barriers to Trade 1868 UNTS 120 (signed 15 April 1994, entered into force 1 January 1995), art 2.2.

84 *United States – Measures Concerning the Importation, Marketing and Sale of Tuna and Tuna Products* WT/DS381/AB/R, 16 May 2012 (Report of the Appellate Body) [*United States – Tuna II*] at [313].

85 At [313].

Kapterian identifies a danger in enabling tribunals to decide whether non-listed policy objectives are legitimate,[86] which may indeed threaten states' regulatory autonomy. However, the approach recommended leaves states' right to set their own regulatory objectives largely untouched, because a tribunal may only assess whether an objective has some ascertainable value at all, and whether the objective is one of breaching the IIA's provisions, which are both low hurdles. This is substantially different to a tribunal's task under a proportionality *stricto sensu* approach, for example.

Using a non-exhaustive list of objectives affords states flexibility while shifting risk towards foreign investors,[87] which some may consider inappropriate. However, tribunals already leave open the range of legitimate objectives when undertaking 'right to regulate' approaches in relation to states' substantive obligations.[88] Moreover, some IIAs contain annexes explaining which regulatory measures do not constitute indirect expropriations, which generally use open-ended lists of legitimate objectives.[89] Most importantly, permissible objectives are the element of an exception clause which should defer most to states' regulatory autonomy. States should not be restricted from setting and/or updating their policy priorities, or responding adequately to unexpected issues. These aims would be threatened by using an exhaustive list, or even by determining the legitimacy of non-listed objectives solely by reference to the listed objectives and/or the objectives considered legitimate in other legal regimes. Consequently, IIA exception clauses should permit objectives fulfilling the legitimacy test outlined above.

2 Unambiguously defining the listed objectives

States should still explicitly list the objectives which they desire to pursue, thus minimising any uncertainty. Kapterian considers, in the GATT context, that every listed objective "represents a policy goal which the WTO community has accepted should remain uncompromised by the pursuit of trade liberalization". [90] This seems even more pertinent regarding IIAs,

86 Gisele Kapterian "A Critique of the WTO Jurisprudence on 'Necessity'" (2010) 59 ICLQ 89 at 116.

87 Van Aaken, above n 8, at 523–524.

88 Mitchell, Munro and Voon, above n 68, at 9. See, for example, *LG&E Decision on Liability*, above n 6, at [195]; and *Pope and Talbot Inc v Canada (Award on the Merits of Phase 2)* (10 April 2001) Lord Dervaird, Benjamin J Greenberg and Murray J Belman, Italaw <www.italaw.com> [*Pope and Talbot*] at [79].

89 See, for example, Dominican Republic – Central America – United States Free Trade Agreement (signed 5 May 2004, entered into force 1 January 2009) [DR-CAFTA], Annex 10-C(4)(b); Korea-Australia Free Trade Agreement [2014] ATS 43 (signed 8 April 2014, entered into force 12 December 2014) [KAFTA], Annex 11-B(5); and Malaysia-Australia Free Trade Agreement [2013] ATS 4 (signed 22 May 2012, entered into force 1 January 2013), Annex on Expropriation, (4).

90 Kapterian, above n 86, at 119.

which have fewer state parties. The "legitimacy" of listed objectives should lie beyond tribunals' review.

IIA exception clauses often copy objectives from the WTO agreements, including public morals,[91] public order[92] and the conservation of exhaustible natural resources.[93] States should, however, define any listed objectives unambiguously, or otherwise risk unexpected tribunal interpretations.

Subjective terms could cause particular problems if interpreted unexpectedly. A WTO panel defined "public morality", for example, as constituting the "standards of right and wrong conduct maintained by or on behalf of a community or nation".[94] Should a state include this objective, it should ensure that tribunals will take such a subjective approach, as the alternative would be to attempt to create a "uniform meaning of the term" between an IIA's state parties whose conceptions of public morality may differ considerably.[95] This could prevent states from justifying entirely well-intentioned measures.

States should also define terms with variable meanings. For example, "public order" has been alternatively interpreted as encompassing concepts of "public peace"[96] and "the preservation of the fundamental interests of a society, as reflected in public policy and law".[97]

Although this is less important where non-listed objectives may already be permitted under a legitimacy test, states should not, as a matter of good practice, hide objectives within other objectives. For example, the AB largely reads the objective of protecting the environment into "the conservation of exhaustible natural resources".[98] The AB seemingly interpreted this objective in an "evolutionary" manner because the preamble of the WTO Agreement indicated the signatories' awareness by 1994 "of the importance and legitimacy of environmental protection", even absent any changes to Article XX.[99] To claim that a contemporary IIA clause incorporates environmental protection

91 GATT, art XX(a); GATS, Art XIV(a). See, for example, Comprehensive Economic Cooperation Agreement between the Republic of India and the Republic of Singapore (signed 29 June 2005, entered into force 1 August 2005) [India-Singapore CECA], art 6.11(a).

92 GATS, art XIV(a). See, for example, India-Singapore CECA, art 6.11(a).

93 GATT, art XX(g). See, for example, Agreement between Canada and the Hashemite Kingdom of Jordan for the Promotion and Protection of Investments (signed 28 June 2009, entered into force 14 December 2009) [Canada-Jordan BIT], art 10(1)(c).

94 *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting* Services WT/DS285/R, 10 November 2004 (Report of the Panel) [*US – Gambling (Panel)*] at [851].

95 Burke-White and von Staden, above n 16, at 364.

96 *Continental Casualty Award*, above n 6, at [174].

97 *US – Gambling (Panel)*, above n 94, at [853].

98 See, for example, *United States – Import Prohibition of Certain Shrimp and Shrimp Products* WT/DS58/AB/R, 12 October 1998 (Report of the Appellate Body) [*US – Shrimp*] at [129]–[130]; and *China – Measures Related to the Exportation of Various Raw Materials* WT/DSS394/AB/R; WT/DS395/AB/R; WT/DS398/AB/R, 30 January 2012 (Reports of the Appellate Body) at [355].

99 *US – Shrimp*, above n 98, at [129]–[130].

by implication would be a weak argument, as the state parties could have explicitly incorporated this objective had they wished to do so.

B. The Nexus Between Measures and Permissible Objectives

The nexus element determines the required relationship between a measure and a permissible objective. Various nexus formulations include "necessary",[100] "relating to",[101] "directed to",[102] "imposed for"[103] and "for".[104] Stricter nexus requirements, such as "necessary", allocate the cost and risk of measures taken in exceptional circumstances towards states.[105]

1 "Necessary"

IIA exception clauses rarely define the term "necessary", despite its ubiquity as a nexus requirement.[106] Where the word "necessary" is used to connect a measure to a legitimate objective, its ordinary meaning would imply assessing whether a state lacked any viable options in achieving that objective other than to interfere with a foreign investment(s) to the extent that it had.[107]

100 See, for example, KAFTA, above n 89, art 22.1(3)(a) and (b); Canada-Jordan BIT, Art 10(1); and Free Trade Agreement between the Government of New Zealand and the Government of the People's Republic of China [2008] NZTS 19 (signed 7 April 2008, entered into force 1 October 2008) [NZ-China FTA], art 200(3). The "necessary" formulation also appears in GATT, art XX(a), (b) and (d); and GATS, art XIV(a), (b) and (c).

101 See, for example, KAFTA, above n 89, art 22.1(3)(d); Agreement between Australia and Japan for an Economic Partnership [2015] ATS 2 (signed 8 July 2014, entered into force 15 January 2015) [JAEPA], art 14.15(e); and Bilateral Investment Treaty Between the Government of the Hashemite Kingdom of Jordan and the Government of the Republic of Singapore (signed 16 May 2004, entered into force 22 August 2005), art 18(e). The "relating to" formulation also appears in GATT, art XX(c), (e) and (g).

102 See, for example, Agreement between the Government of the Republic of Mauritius and the Government of the Republic of India for the Promotion and Protection of Investments (signed 4 September 1998, entered into force 20 June 2000), art 11(3).

103 See, for example, KAFTA, above n 89, art 22.1(3)(c); and JAEPA, above n 101, art 14.15(d). The "imposed for" formulation also appears in GATT, art XX(f).

104 See, for example, Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of India for the Promotion and Protection of Investments (signed 14 March 1994, entered into force 6 January 1995), art 11(2).

105 Burke-White and von Staden, above n 16, at 348.

106 Footnote 6 to Indian Model BIT 2016, art 32.1, provides a rare counterexample, explaining that "[i]n considering whether a measure is 'necessary,' the Tribunal shall take into account whether there was no less restrictive alternative measure reasonably available to a Party".

107 Donald H Regan "The meaning of 'necessary' in GATT Article XX and GATS Article XIV: the myth of cost-benefit balancing" (2007) 6 World Trade Review 347 at 348, agrees that comparing the measure adopted with alternatives is "what is suggested most naturally by the word 'necessary'".

The meaning given to this term is not universal, however. For example, some tribunals used elements of the customary necessity defence,[108] while the *Continental* tribunal used WTO jurisprudence,[109] to ascertain the meaning of "necessary" under Article XI of the US-Argentina BIT. The term should be defined so as to ensure certainty in its interpretation. The customary and WTO conceptions are worth considering in determining how to define "necessary" in an IIA exception clause (if "necessary" should indeed be the formulation used).

(a) "Necessity" under customary international law

The customary necessity defence, which can render a state's breach of an international obligation non-wrongful,[110] is widely considered to be codified by Article 25 of the International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts,[111] which reads:

> 1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
>
> (a) is the only way for the State to safeguard an essential interest against a grave and imminent peril; and

108 See above n 58 and accompanying text. For criticisms of this approach, see, for example, Diane A Desierto "Necessity and Supplementary Means of Interpretation for Non-Precluded Measures in Bilateral Investment Treaties" (2010) 31 U Pa J Intl L 827, at 843–844, 850–852 and 858; Burke-White and von Staden, above n 16, at 396–397; and Kurtz, above n 72, at 344–347.

109 *Continental Casualty Award*, above n 6, at 192. For criticisms of this approach, see, for example, Desierto, above n 108, at 875, 882 and 889–893; and Gabriele Gagliani "The Interpretation of General Exceptions in International Trade and Investment Law: is a Sustainable Development Interpretive Approach Possible?" (2015) 43 Denv J Intl L & Poly 559 at 580.

110 *Gab*číkovo-Nagymaros Project (Hungary v Slovakia) [1997] ICJ Rep 7 [*Gab*číkovo-Nagymaros Project] at [48] and [51]; and *Legal Consequences of a Construction of a Wall in the Occupied Palestinian Territory*, above n 129, at [140].

111 See for example, *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries* A/56/10 (2001) [*Draft articles on State Responsibility with commentaries*] at 31; Abba Kolo and Thomas Wälde "Economic crises, capital transfer restrictions and investor protection under modern investment treaties" (2008) 3 CMLJ 154 at 164; Eric David Kasenetz "Desperate Times Call for Desperate Measures: the Aftermath of Argentina's State of Necessity and the Current Fight in the ICSID" (2009) 41 George Washington International Law Review 709 at 719–720; and James Crawford and Simon Olleson "The Character and Forms of International Responsibility" in Malcolm D Evans (ed) *International Law* (4th ed, Oxford University Press, Oxford, 2014) 443 at 464–465. See, also, *Legal Consequences of a Construction of a Wall in the Occupied Palestinian Territory* [2004] ICJ Rep 136 at [140]; and *Gab*číkovo-Nagymaros *Project*, above n 110, at [51]–[52].

(b) does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.

2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:
   (a) The international obligation in question excludes the possibility of invoking necessity; or
   (b) The State has contributed to the situation of necessity.

The only element of Article 25 which could assist in defining "necessary" is the requirement that an act be the "only way" of achieving an objective. The other elements do not address the choices available to a state in pursuing an objective, which is the ultimate concern of a "necessary" nexus element.

The "only way" element requires a state to have no "other (otherwise lawful) means available, even if they may be more costly or less convenient",[112] in achieving its objective. This is rather harsh. Ismailov argues that its consideration of alternatives, "irrespective of [their] viability and reasonableness, makes it impossible for a state to invoke it successfully in practice".[113] If states must shoulder an *excessive* burden in pursuing an objective, they may be unable to pursue it at all.

The *Enron* annulment committee expressed concern that strict interpretations of the "only way" requirement may prohibit a state from adopting an unlawful measure likely to achieve an objective where it could adopt a lawful measure with a significantly lower likelihood, but still some prospect, of doing so.[114] If a state could not take the former kind of measure, it may be unable to respond satisfactorily to policy concerns.

Moreover, the "only way" requirement seemingly promotes uncertainty. The *LG&E* tribunal found that the same Argentine measures, characterised by other tribunals as not constituting the "only means" to respond to the crisis, *were* in fact the "only means" available to do so.[115] This requirement therefore neither ensures nor clarifies states' right to regulate.

112 *Draft articles on State Responsibility with commentaries*, above n 111, at 83; see also *Sempra Energy International v Argentina (Rejoinder Opinion of Anne-Marie Slaughter and William Burke-White)* ICSID ARB/03/02, 2 December 2005 at [47], referring to *Gab*číkovo-Nagymaros Project.

113 Otabek Ismailov "Interaction of International Investment and Trade Regimes on Interpreting Treaty "Necessity" Clauses: Convergence or Divergence?" (2017) 48 Georgetown Journal of International Law 505 at 514.

114 *Enron Decision on Annulment*, above n 6, at [371].

115 *LG&E Decision on Liability*, above n 6, at [257]. The tribunal had already excused Argentina under Article XI anyway, at [245]. See also Jorge E Viñuales "State of Necessity and Peremptory Norms in International Investment Law" (2008) 14 Law and Business Review of the Americas 79 at 80–81.

(b) "Necessary" in WTO jurisprudence

A definition of "necessary" in an IIA exception clause could also be inspired by WTO jurisprudence, in which its meaning has been elaborated in a series of cases. Of course, international trade and investment are regulated "in ways that are dramatically different".[116] For example, the remedies under IIAs (primarily the payment of compensation) and the WTO agreements (the replacement or reformation of the unlawful measure) differ considerably.[117] The diffuse nature of international investment law can be contrasted with the unified WTO regime.[118]

However, as Mitchell and Henckels identify, both WTO law and IIAs are ultimately concerned with whether a measure, perhaps adopted for a public purpose, complies with a state's "obligations affecting commercial entities".[119] Exception clauses under both regimes delineate when a measure's contribution to a legitimate policy objective overrides its *prima facie* inconsistency with a state's international economic obligations, thus affecting the balance between states' right to regulate and the protection of foreigners' economic rights. It is thus perfectly legitimate to seek inspiration from WTO jurisprudence in designing an IIA exception clause, whilst accounting for any relevant differences between these regimes.

In order to determine a measure's "necessity" under WTO law, a panel must "weigh and balance" various factors, most prominently the "importance of the objective" pursued by the measure, the measure's "contribution … to that objective", and the measure's "trade-restrictiveness".[120] A measure need not necessarily contribute to, but must at least be "apt to make a material contribution to the achievement of", a permissible objective.[121] Proving this could entail the use of future "quantitative projections …, or qualitative reasoning based on a set of hypotheses that are tested and supported by sufficient evidence".[122]

The WTO necessity test also includes a so-called 'least-restrictive-means' analysis, whereby the measure adopted is compared with alternative measures, in order to ascertain whether "an alternative measure which it could reasonably be expected to employ" and which is consistent, or is less inconsistent, with

116 Nicholas DiMascio and Joost Pauwelyn "Nondiscrimination in Trade and Investment Treaties: Worlds Apart or Two Sides of the Same Coin" (2008) 102 AJIL 48 at 48.

117 Desierto, above n 108, at 875 and 884–890.

118 Barton Legum and Ioana Petculescu "GATT Article XX and international investment law" in Roberto Echandi and Pierre Sauvé (eds) *Prospects in International Investment Law and Policy* (Cambridge University Press, Cambridge, 2013) 340 at 351.

119 Mitchell and Henckels, above n 52, at 95.

120 *European Communities – Measures Prohibiting the Importation and Marketing of Seal Products* WT/DS/400/R; WT/DS401/AB/R, 22 May 2014 (Reports of the Appellate Body) [*EC – Seal Products*] at [5.169].

121 *Brazil – Measures Affecting Imports of Retreaded Tyres* WT/DS332/AB/R, 3 December 2007 (Report of the Appellate Body) [*Brazil – Retreaded Tyres*] at [150].

122 At [151].

the GATT and/or GATS was available to the state, in which case the chosen measure will not be "necessary".[123]

An alternative measure is not "reasonably available" if it prevents a state "from achieving its chosen level" of protection of an objective, even if it is less trade-restrictive;[124] it must "be less trade restrictive while providing an equivalent contribution to the achievement of the objective pursued".[125] In *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products* (*China – Audiovisual Products*), the AB demonstrated the interaction between these principles in finding that a:[126]

> … proposed alternative would be less restrictive and would make a contribution that is at least equivalent to the contribution made by the measures at issue to securing [the state's] level of protection …

of the given objective.

Moreover, a "merely theoretical" alternative measure is not "reasonably available", for example where a state "is not capable of taking it, or where the measure imposes an undue burden on that [state], such as prohibitive costs or substantial technical difficulties".[127] The respondent bears the burden of demonstrating that its measure fulfils the exception clause's requirements, but does not bear the "burden to show … that there are *no* reasonably available alternatives to achieve its objectives".[128]

The foregoing seemingly represents the current meaning of "necessary" in WTO jurisprudence. The *Continental* tribunal endorsed the 'weighing and balancing' and 'least-restrictive-means' tests.[129] The tribunal found, firstly, that Argentina's measures had been "apt to and did make such a material or decisive contribution" to the protection of Argentina's security interests.[130] It then found that "Argentina had no other reasonable choice available, in order to protect its essential interests …, than to adopt" the measures,[131] and

123 *United States – Section 337 of the Tariff Act of 1930* L/6439 – 36S/345, 16 January 1989 (Report of the Panel) [*United States – Section 337*] at [5.26].

124 *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products* WT/DS135/AB/R, 12 March 2001 (Report of the Appellate Body) [*EC – Asbestos*] at [174].

125 *Brazil – Retreaded Tyres*, above n 121, at [156].

126 *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products* WT/DS363/AB/R, 21 December 2009 (Report of the Appellate Body) [*China – Audiovisual Products*] at [355].

127 *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services* WT/DS285/AB/R, 7 April 2005 (Report of the Appellate Body) [*US – Gambling (AB)*] at [308].

128 *US – Gambling (AB)*, above n 127, at [309] (emphasis in original).

129 *Continental Casualty Award*, above n 6, at [194]–[195].

130 At [196]–[197]

131 At [199] and [231].

dismissed all but one claim against Argentina.[132] This contrasts sharply with the unfavourable outcomes for Argentina in *CMS*, *Sempra*, and *Enron*.[133] Accordingly, using the WTO conception of necessity may well promote the right to regulate.

Nevertheless, certain aspects of the WTO conception should not be followed when defining "necessary" in an IIA exception clause. The 'weighing and balancing' approach is particularly problematic.

The AB has repeatedly emphasised that states determine their own desired level of achievement of their objectives.[134] Indeed, it would otherwise be pointless to permit a state to regulate towards an objective at all. However, as Regan notes, this principle is inconsistent with the factors to be "weighed and balanced".[135] If a panel (or tribunal) is weighing "the benefits from the measure in the achievement of that goal against the cost of the measure in reduced trade [or harm to investment]", this will prevent a state from choosing its own level of protection in adopting a measure, because this "test" will examine, in essence, whether a measure achieving a legitimate objective should be prohibited because its benefits regarding that objective "do not justify the trade [or investment] costs".[136] He notes that the AB, despite constantly articulating the "weighing and balancing" of factors, ultimately only applied the "least-restrictive-means" test to the facts in various cases, treating as "determinative … the principle that [states] get to choose their own level of protection".[137] Other commentators reach similar conclusions,[138] and it is indeed difficult to discern the impact of any 'weighing and balancing' on the factual decision in recent cases such as *China – Audiovisual Products*,[139] for example.

This makes sense when one considers that none of the factors involved indicate, in themselves, a measure's necessity *for achieving a given legitimate objective*, which is the function that a nexus element performs. An objective's importance, for example, indicates nothing about whether a state "needed" to take a particular measure in order to contribute to the achievement of that very objective. To take into account an objective's importance seems to contemplate an assessment of the 'necessity' of the objective itself rather than

132 At [304] and [319].

133 Kathleen Claussen "The Casualty of Investor Protection in Times of Economic Crisis" (2009) 118 The Yale Law Journal 1545 at 1548. See also above n 60 and accompanying text.

134 See, for example, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef WT/DS169/AB/R, 11 December 2000 (Report of the Appellate Body)* [*Korea – Beef*] at [176]; *EC – Asbestos*, above n 124, at [174]; *US – Gambling (AB)*, above n 127, at [308]; and *Brazil – Retreaded Tyres*, above n 130, at [170].

135 Regan, above n 107, at 347–348.

136 At 348.

137 At 348 (referring to the AB decisions in *Korea – Beef*, *EC – Asbestos*, *US – Gambling* and *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes* WT/DS302/AB/R, 25 April 2005 (Report of the Appellate Body)).

138 See, for example, Mitchell, Munro and Voon, above n 68, at 26.

139 See *China – Audiovisual Products*, above n 126, at [355].

of the measure, a value-judgment which should not be made by tribunals. An analysis of a measure's importance need not, and should not, enter an exception clause's 'necessity test'.

The degree to which a measure contributes to an objective, or its degree of restriction of international investment, also do not in themselves indicate the measure's necessity in pursuing a given objective. These factors must be determined only because they enable the chosen measure to be compared to alternative measures in respect of their contribution to that objective and degree of investment-restrictiveness. This is because a true necessity analysis entails demonstrating whether a state, in pursuing its desired level of protection of a particular objective, had a choice in adopting the chosen investment-restrictive measure.

Indeed, the AB's 'weighing and balancing' test appears to convolutedly mix the 'suitability' and 'proportionality *stricto sensu*' stages of a proportionality analysis. An exception clause will inadequately preserve a state's regulatory autonomy if a tribunal's assessment of an objective's importance, weighed against the importance of investment protection, may override the state's judgment in this respect. The "weighing and balancing of factors" should therefore be excluded from the clause's definition of "necessary".

An IIA exception clause should instead provide that "necessity" is to be assessed through a least-restrictive-means test, whereby a measure is not "necessary" where a reasonably available and less investment-restrictive alternative measure would contribute more or equally effectively to the state's chosen level of protection of its objective. For an alternative measure to be "reasonably available", the formulation that it not be "merely theoretical in nature" should be adopted. Unlike the customary "only way" test, this would permit tribunals "to consider only practical and possible means",[140] and not alternative measures which a state would be incapable of taking, such as those which would impose an undue burden. A measure's "aptness" to contribute to an objective should be taken into account. This would enable the justification of measures whose individual effect may be impossible to measure, but which may be predicted from research (such as climate change mitigation measures, as the AB perceptively noted).[141]

Raju claims that a least-restrictive-means test is "unworkable" in the investment context, given the sheer number of investors potentially affected by measures, thus rendering states unable to properly judge *ex ante* how their measures may affect prospective claimants.[142] However, if the AB's approach to the burden of proof is followed, a claimant would have to establish the existence of any reasonably available less investment-restrictive alternative measure. If investors, who are more remotely situated to a states' regulatory options, are expected to do this, then surely a state can contemplate such

140 Ismailov, above n 113, at 552.

141 *Brazil – Retreaded* Tyres, above n 121, at [151].

142 Deepak Raju "General exceptions in the Indian model BIT: Is the 'necessity' test workable?" (2016) 7 Jindal Global Law Review 227 at 233 and 237–238.

alternatives while regulating. In any case, it is desirable to force states to regulate in as least an investment-restrictive manner as possible, and if they attempt do so, it may well be unnoticeable that some unidentified less investment-restrictive alternatives were reasonably available.

Perhaps one could criticise the lack of 'weighing and balancing' in the suggested meaning of "necessary", which might result in a severely investment-restrictive measure which barely contributes to a legitimate objective being found to be 'necessary'. However, it is worth mentioning again the example of climate change mitigation measures. An individual measure may make an extremely remote contribution to the mitigation of climate change, and may be severely investment-restrictive, but this does not *per se* preclude its "necessity" vis-à-vis this legitimate aim. Application of the least-restrictive-means test will usually exclude justification of the most severely investment-restrictive forms of achieving a legitimate objective anyway. Thereafter, the state's right to regulate should prevail, subject to a measure also fulfilling the clause's other conditions.

2 More lenient nexus formulations

To the author's knowledge, no exception clause with a nexus requirement other than "necessary" has been assessed in investment arbitration. The AB's conception of the "relating to" nexus element requires that a measure be "primarily aimed at" an objective,[143] which contemplates "a close and genuine relationship of ends and means" between the measure and objective.[144] An IIA need not follow this conception, but the primary problem with less stringent nexus requirements is that the least-restrictive-means test conceived in the recommended clause already enables states to adopt the reasonably available measure which will best achieve their desired level of protection of a legitimate objective, whilst also preventing tribunals from overriding this choice of protection, thus preserving states' right to regulate. It is unclear why states should not then be obliged to find the method of doing so which interferes least with international investment, considering IIAs' overall purpose of protecting investors.

Overall, necessity, conceptualised using the least-restrictive-means test suggested above, is the nexus requirement which accounts most fairly for the interests of both states and investors, whilst also minimising any uncertainty.

C. Self-judging Language

Some exception clauses contain so-called self-judging language, generally comprising the phrase "it [the state] considers". This frequently appears

143 *United States – Standards for Reformulated and Conventional Gasoline* WT/DS2/AB/R, 29 April 1996 (Report of the Appellate Body) [*US – Gasoline*] at 18–19.

144 *US – Shrimp*, above n 98, at [136].

alongside a "necessary" nexus requirement in security exceptions, probably inspired from the WTO security exception clauses which allow a state to take "any action which *it considers* necessary for the protection of its essential security interests …".[145] Article 22(2) of the COMESA Investment Agreement is particularly lenient, allowing states to adopt measures "that [they] consider *appropriate*" for various permissible objectives. The usual positioning of self-judging language suggests that it only concerns the permissible objective and nexus elements.

1 The effect of self-judging language

Van Aaken identifies three potential readings for self-judging clauses: firstly, that their invocation is subject to no tribunal scrutiny; secondly, that they remain subject to a good faith review; or, thirdly, that they remain subject to a tribunal's full scrutiny.[146]

The first view was implied in the International Court of Justice's (ICJ) statement in *Military and Paramilitary Activities in and against Nicaragua* that it could judge the invocation of an exception clause which, unlike Article XXI GATT, did *not* include the word "considers" before the word "necessary".[147] However, the prevailing contemporary view is that unless self-judging clauses explicitly exclude external arbitration,[148] their invocation simply alters tribunals' "standard of review".[149] "Good faith review" is the term generally used to describe the standard of review permitted.[150] Various tribunals examining Argentina's invocation of Article XI of the US-Argentina BIT found that, had Article XI been self-judging, they could have adopted a good faith review.[151] The *Continental* tribunal considered that this would preclude it "from entering further into the merits",[152] but the *LG&E* tribunal

145 GATS, art XIV bis; GATT, art XXI. For examples in BITs, see KAFTA, above n 89, art 22.2; and Treaty between the Government of the United States of America and the Government of the Republic of Rwanda Concerning the Encouragement and Reciprocal Protection of Investment (signed 19 February 2008, entered into force 1 January 2012), article 18(2).

146 Van Aaken, above n 8, at 524.

147 *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America) (Merits)* [1986] ICJ Rep 14 at [222]. See also Stephan Schill and Robyn Briese "'If the State Considers': Self-Judging Clauses in International Dispute Settlement" (2009) 13 Max Planck Yrbk UN L 61 at 98–99.

148 See, for example, footnote 2 to Article 22.2(b) of the United States – Peru Trade Promotion Agreement (signed 12 April 2006, entered into force February 1 2009), which states that "if a Party invokes Article 22.2 in an arbitral proceeding initiated under Chapter Ten (Investment) …, the tribunal or panel hearing the matter shall find that the exception applies".

149 Schill and Briese, above n 147, at 97.

150 See, for example, Burke-White and von Staden, above n 16, at 370; and Schill and Briese, above n 147, at 66.

151 *Sempra Award*, above n 6, at [388]; *Enron Award*, above n 6, at [339]; *LG&E Decision on Liability*, above n 6, at [214]; and *Continental Casualty Award*, above n 6, at [182].

152 At [182].

suggested that a good faith review would essentially resemble "the substantive analysis" undertaken without a self-judging clause.[153] What good faith review entails was otherwise unelaborated.[154]

The ICJ's decision in *Certain Questions of Mutual Assistance in Criminal Matters (Djibouti v France)*[155] dealt with the actual application of a self-judging exception clause in the mutual assistance treaty between France and Djibouti.[156] In the ICJ's view, France merely had to provide reasons for its non-compliance with the convention in order to fulfil its good faith requirement.[157] Judge Keith's separate Declaration linked good faith with concepts of abuse of rights and misuse of power, stipulating that "the State agency in question [must] exercise the power for the purposes for which it was conferred and without regard to improper purposes or irrelevant factors".[158]

Scholars have conceptualised a good faith review in various ways. Van Aaken contends that tribunals should check the "legality" but not the "expediency" of governmental actions.[159] Burke-White and von Staden suggest first examining whether a "state has acted honestly and to the best of its ability" in invoking an exception clause, which would not be the case where a state does so with "ulterior economic motives, or where the connection between the measures taken and [the objective] is so spurious as to clearly breach the good faith requirement".[160] This would require that the self-judging exception not be intentionally misused.[161] They suggest secondly determining whether any objectively rational basis exists for invoking the clause.[162] Burke-White and von Staden's conception resembles some form of substantive review. Part of the first element, which they submit is aimed at avoiding misuse of the exception clause, and which they connect to a state's "ulterior motives", appears remarkably similar to the chapeau analysis under the WTO general exception clauses, which aims to prevent exceptions from being "abused or misused".[163] This is remarkable, given that self-judging language seems to concern only whether the measure is "necessary" vis-à-vis a permissible objective anyway. It would therefore enable an arguably more comprehensive analysis than the ordinary one in self-judging clauses containing no chapeau, and a superfluous analysis in self-judging clauses

153 At [214].

154 Schill and Briese, above n 147, at 113.

155 *Certain Questions of Mutual Assistance in Criminal Matters (Djibouti v France)* [2008] ICJ Rep 177.

156 Schill and Briese, above n 147, at 113–114.

157 *Djibouti v France*, above n 155, at [145]–[156]. See also Schill and Briese, above n 147, at 116.

158 *Djibouti v France*, above n 155, Declaration of Judge Keith at [5]–[6].

159 Anne van Aaken "Smart Flexibility Clauses in International Investment Treaties and Sustainable Development: A Functional View" (2014) 15 The Journal of World Investment & Trade 827 at 855.

160 Burke-White and von Staden, above n 16, at 379.

161 At 380.

162 At 380.

163 *US – Gasoline*, above 143, at 22.

already containing a chapeau. The analyses as to whether the connection between a measure and objective is "spurious", and whether any objectively rational basis for invoking the clause is ascertainable, seemingly replace the "necessary" nexus requirement with a weaker one.

2 Should IIA exception clauses include self-judging language?

There appear to be three different options for IIA exception clauses: firstly, explicitly excluding tribunals' jurisdiction over a state's invocation of the clause; secondly, using traditional "it considers" language which permits good faith review; or, thirdly, including no self-judging language.

The first approach would amount to designating a policy area(s) in which investors' claims may not succeed, as tribunals could not examine states' invocation of such clauses (assuming non-justiciability covers the whole clause).[164] This has been characterised as "an invitation to abuse"[165] and a means of "[rendering] treaty exceptions entirely illusory",[166] and it would nullify the particular balancing advantages of exception clauses.

Permitting good faith review is only somewhat less problematic. The character of good faith review is clearly unsettled. Gibson finds "no significant difference between self-judging and non-self-judging provisions", if the former type of clause will be subject to a good faith review.[167] The *LG&E* tribunal's statements suggest that this is how tribunals may approach a good faith review. The conceptions of Burke-White and von Staden, and of Judge Keith, allow for a weaker form of substantive review, seemingly preserving a kind of chapeau requirement (which is superfluous where a clause already contains a chapeau separate from the nexus and permissible objective elements, as this paper recommends). Moreover, merely examining whether the connection between a measure and a legitimate objective is "spurious", or seeking a "rational basis" for invoking the clause, as Burke-White and von Staden suggest, leaves far too much discretion to tribunals, and does not offer the moderating advantages of the least-restrictive-means test. The *Djibouti v France* approach is even more deferential to states, apparently only requiring them to provide reasons.

Perhaps more lenient approaches are more appropriately taken regarding crisis situations, where a state may not have been able to easily undertake a full least-restrictive-means analysis.[168] However, this paper's necessity test protects states from having to take measures where they are incapable of doing so, which will already provide breathing room during crises. Moreover, as tribunals have noted, it is precisely during circumstances of crisis that

164 For an example of such a clause, see above n 148 and accompanying text.

165 Van Aaken, above n 159, at 855.

166 Vandevelde, above n 82, at 455.

167 Catherine H Gibson "Beyond Self-Judgment: Exceptions Clauses in US BITs" (2015) 38 Fordham Intl LJ 1 at 33.

168 Van Aaken, above n 159, at 846.

international guarantees of investors' rights become particularly important.[169] To offload the costs and risks of crises entirely on investors is unfair.

Good faith review seems either to provide states with little additional regulatory leeway anyway, if a tribunal shares the *LG&E* tribunal's view, or to unduly undermine investment protection. IIA exception clauses should thus exclude self-judging language.

D. Inclusion of a Chapeau

Article XX GATT and Article XIV GATS contain an introductory paragraph, known as a chapeau, which must be satisfied in addition to an exception clause's other requirements.[170] The chapeau to Article XX GATT reads:

> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures …

IIA exception clauses often contain a chapeau, albeit with modified wording to fit the investment context.[171]

1 Should IIA exception clauses include a chapeau?

According to the AB, the chapeau prevents abuse and misuse of the exceptions.[172] The chapeau has alternatively been characterised as providing a "second check" ensuring measures' application in "good faith".[173] Another conception of the chapeau's role is in revealing any "protectionist motivation behind the veil of public interest".[174] To impose conditions ensuring a state's non-abusive invocation of an exception clause is desirable, particularly where

169 *Enron Award*, above n 6, at [331].

170 Mitchell, Munro and Voon, above n 68, at 27; Peter Van den Bossche and Denise Prévost *Essentials of WTO Law* (Cambridge University Press, Cambridge, 2016) at 100.

171 See, for example, Agreement between the Government of Romania and the Government of Canada for the Promotion and Reciprocal Protection of Investments (signed 8 May 2009, entered into force 23 November 2011), art XVII(3), which refers to "discrimination between investments or between investors" and "a disguised restriction on international trade or investment".

172 *US – Gasoline*, above n 143, at 22.

173 Mitchell and Henckels, above n 52, at 135.

174 David Collins "The line of equilibrium: improving the legitimacy of investment treaty arbitration through the application of the WTO's general exceptions" (2016) 32 Arbitration International 575 at 578. See also Riffel, above n 71, at 145.

states (who select their desired level of protection of a legitimate objective) largely set the parameters of the least-restrictive-means test under the recommended exception clause.

2 Elements of a chapeau

(a) "Arbitrary or unjustifiable discrimination"

The WTO chapeaux prohibit "arbitrary or unjustifiable discrimination between countries where the same conditions prevail". Riffel argues that the phrase "restriction on international trade [or investment]", subsequently appearing in the chapeaux, already encompasses "discrimination", as the AB itself appears to have recognised,[175] and that any "discrimination" element could thus be removed altogether.[176] Discrimination against foreign investments, implying disadvantageous treatment of them, would likewise always "restrict" such investments. If a chapeau mentions the broader concept of a "restriction" on international investment, it need not mention "discrimination".

In terms of the adjectives attached to the prohibited discrimination (or, rather, restrictions), Riffel contends that the term "unjustifiable" ultimately equates to the term "arbitrary", noting that the AB does not distinguish these terms in its jurisprudence.[177] Dolzer and Schreuer consider these terms, as well as "unreasonable", to share the same meaning.[178] Riffel argues that a chapeau need not therefore include the word "unjustifiable".[179] Considering the design of the nexus requirement in this paper's recommended clause, however, it is almost impossible to envisage any situation where an "arbitrary" restriction, meaning one taken "capriciously or without reason"[180] (implying a negligible contribution to a permissible objective) was the least-investment-restrictive means of achieving this objective to the state's chosen level of protection. To analyse this within a chapeau therefore adds nothing to the analysis already undertaken in the recommended clause.

(b) "Disguised restriction on international trade or investment"

A measure can also fail under the WTO chapeaux where its application constitutes "a disguised restriction on international trade". A closer examination may reveal that instead of being aimed at a legitimate objective

175 *US – Gasoline*, above n 143, at 25.

176 Riffel, above n 71, at 157–158 and 175.

177 Riffel, above n 71, at 150. See, for example, *Brazil – Retreaded Tyres*, above n 121, at [232]; and *EC – Seal Products*, above n 120, at [5.328].

178 Dolzer and Schreuer, above n 8, at 200.

179 Riffel, above n 71, at 150.

180 *National Grid PLC v Argentina (Award)* Alejandro Miguel Garro, Judd L Kesslera and Andrés Rigo Sureda 1:09-cv-00248-RBW, 3 November 2008 at [197].

as claimed, a measure actually pursues "protectionist" ends.[181] The fact that a measure contributes to a state's chosen level of protection of a legitimate objective does not prove that the state actually sought to pursue that objective; a chapeau examining whether a measure's true motive is to restrict international investment could thus complement the analysis undertaken elsewhere in the recommended clause.

Bartels considers this element particularly valuable in catching out measures "adopted for a mixture of proper and improper purposes".[182] He questions, however, whether the chapeau should prohibit "only measures with a *sole* or *primary* illegitimate purpose or [whether] it should also include … measures with *any* illegitimate purpose", even where the illegitimate purpose may be minor in comparison to the legitimate purpose.[183]

It is argued that *any* ascertainable objective to restrict investment as an end in itself should preclude a measure's justification. One may ask, if a measure's necessity towards a legitimate objective is established, thus demonstrating its public utility, why it matters that it was adopted with an ulterior motive.

Firstly, exceptions from a legal regime should not be able to justify measures aimed directly at breaching that same legal regime. As the overarching objective of IIAs is to protect foreign investors, their clauses must never be relied upon as a pretext for restricting investors' rights as an end in itself. Foreign investors, having already expended substantial time, effort and resources into their investment, should not be expected to bear the costs of a measure which is intended to harm their interests.

Secondly, a measure satisfying the "necessity" analysis conceived in this paper will be the least investment-restrictive measure reasonably available to the host state which achieves, to the greatest extent possible, *its chosen level of protection* of a legitimate objective. This creates some potential for abuse, such as where a state uses a legitimate objective as a smokescreen for its true intentions, which must be prevented. If a state's ultimate intention in regulating was solely to achieve the legitimate objective chosen, and its measure passes the least-restrictive-means test, this suggests that the state has truly tried to minimise the measure's investment-restrictive impact as much as possible. If a state regulates with any ulterior objective of restricting international investment, however, then it seems paradoxical to claim that a state has truly strived to minimise the restrictive effect of its regulation on foreign investment.

Accordingly, the chapeau should operate to prevent the justification of a measure with any ascertainable objective to restrict international investment as an end in itself. Ascertaining this ulterior objective could entail examining the wider circumstances in which the state adopted the measure concerned, and not simply a measure's "application", as the WTO formulation implies.

181 Van den Bossche and Prévost, above n 170, at 104.

182 Lorand Alexander Bartels "The chapeau of the general exceptions in the WTO GATT and GATS agreements: a reconstruction" (2015) 109 AJIL 95 at 123.

183 At 123.

Unfortunately, this will provide tribunals with more discretion than some may like, but it is difficult to conceptualise a more rigid test for ascertaining a state's ultimate intentions. The author agrees with Riffel that a chapeau should never permit proportionality *stricto sensu* analysis,[184] for reasons repeatedly emphasised above. Therefore, an ulterior investment-restrictive motive should never be ascertained simply because the importance of a legitimate objective seems, in a tribunal's view, not to justify a measure's investment-restrictive impact.

Rather, useful indicators would arise from the state's broader legislative regime and conduct,[185] and the measure's political context. One indicator is the importance which a state genuinely appears to accord to the claimed legitimate objective. If a state has taken, or is taking, no other actions in pursuit of this objective, this would strongly indicate that it does not truly prioritise that objective, which has instead been used to mask its true intentions. These "other actions" could include measures which would contribute to the legitimate objective to a lesser degree, which would not be contemplated by the least-restrictive-means test. Another indicator could be that the timing and nature of a specific measure demonstrates that it is really a response to domestic circumstances, such as pressure to target a particular investor.

In summary, the recommended clause's chapeau should prevent justification of measures which are "ultimately intended as a restriction on international investment", accompanied by a footnote recommending a holistic analysis akin to that just described.

E. Scope

Exception clauses may apply to all obligations in an IIA, or only to particular obligations. The Comprehensive Economic and Trade Agreement (CETA) provides an example of the latter:[186]

> 2. *For the purposes of … Sections B (Establishment of Investments) and C (Non-discriminatory treatment)* of Chapter Eight (Investment), … nothing in this Agreement shall be construed to prevent the adoption or enforcement by a Party of measures …

Two prominent arguments for excluding certain obligations from exception clauses' scope have arisen. Firstly, conflicts might arise between such clauses and the 'right to regulate' analyses undertaken when assessing

184 Riffel, above n 71, at 173.

185 Burke-White and von Staden, above n 16, at 379.

186 Comprehensive Economic and Trade Agreement (CETA) between Canada, of the one Part, and the European Union and its Member States, of the Other Part, European Union-Canada (signed 30 October 2016, not yet in force), art 28.3(2).

whether a *prima facie* breach of a state's obligation(s) has occurred. Secondly, the character of certain obligations may render their justification impossible and/or undesirable.

1 Potential conflicts with other 'right to regulate' analyses

(a) 'Right to regulate' analyses in tribunal jurisprudence

Some commentators contend that where particular obligations fall within an exception clause's scope, tribunals may interpret them more narrowly in investors' favour, thus actually reducing states' regulatory autonomy.[187] However, as mentioned previously, tribunals often apply a proportionality *stricto sensu* approach in assessing whether a measure constitutes a breach of FET[188] or an indirect expropriation.[189] This paper's recommended exception clause is specifically designed to avoid subjecting states' measures to a proportionality *stricto sensu* analysis, precisely because allowing tribunals to weigh states' policy objectives against the interest of investment protection unduly interferes with states' regulatory autonomy. Moreover, entirely well-intentioned measures could conceivably fail a proportionality *stricto sensu* test, due to its subjectivity, yet pass a least-restrictive-means test.

Tribunals' 'right to regulate' approach regarding national treatment is different. After ascertaining whether a foreign investor received less favourable treatment than national investors in like circumstances, tribunals consider whether any differing treatment was justified by a legitimate public policy objective.[190] This latter analysis is rather lenient, involving no "necessary" nexus requirement nor chapeau.[191] Indeed, tribunals have asked, *inter alia*,

187 See, for example, Andrew Newcombe "General Exceptions in International Investment Agreements" (Draft Discussion Paper prepared for BIICL Eighth Annual WTO Conference, 13 and 14 May 2008) at 10–11; and Mitchell, Munro and Voon, above n 68, at 41–42.

188 See above n 66 and accompanying text. For more examples, see *EDF (Services) Ltd v Romania (Award)* ICSID ARB/05/13, 8 October 2009 at [293]; *Total SA v Argentina (Decision on Liability)* ICSID ARB/04/1, December 27 2010 at [162]; and *Philip Morris v Uruguay*, above n 93, at [409].

189 See above n 67 and accompanying text. For more examples, see *Fireman's Fund Insurance Co v Mexico (Award)* ICSID ARB(AF)/02/1, 17 July 2006 at [176]; *Archer Daniels Midland Co v Mexico (Award)* ICSID ARB(AF)/04/5, 21 November 2007 at [250]; *Suez, Sociedad General de Aguas de Barcelona SA v Argentina (Decision on Liability)* ICSID ARB/03/17, 30 July 2010 at [147]–[148]; and *Philip Morris v Uruguay*, above n 93, at [306].

190 Louis-Marie Chauvel "The Influence of General Exceptions on the Interpretation of National Treatment in International Investment Law" (2017) 14 Direito Internacional dos Investimentos 140 at 142; and Dolzer and Schreuer, above n 8, at 205–209. See, for example, *Pope and Talbot*, above n 88, at [78]; and *Feldman Award*, above n 53, at [184].

191 Céline Lévesque "The inclusion of GATT Article XX exceptions in IIAs: a potentially risky policy" in Roberto Echandi and Pierre Sauvé *Prospects in International Investment Law and Policy* (Cambridge University Press, Cambridge, 2013) 363 at 365–366.

whether there was "a reasonable nexus to",[192] a reasonable pursuit of,[193] or a plausible connection with, a legitimate objective.[194] However, the requirements under the recommended exception clause are hardly excessively stringent. A measure must be the least investment-restrictive means of achieving its chosen level of protection of a public policy objective (whose legitimacy is presumed if listed, and easily established otherwise), and be adopted without an ulterior motive of restricting international investment. To use a lesser nexus requirement does not sufficiently encourage states to regulate with a view to minimising any interference with investors' rights, thereby needlessly shifting the risks and costs of regulation onto investors. Despite the absence of an explicit chapeau in tribunals' 'right to regulate' analyses, it seems doubtful that a tribunal would excuse a measure with ultimately protectionist motives, but such measures do not deserve justification anyway.

(b) The 'right to regulate' in expropriation annexes

Greater difficulties may arise from explicit "right to regulate" clauses applying to obligations, such as the expropriation annexes found in some IIAs. For example, Annex 10-C(4)(b) to the Dominican Republic – Central America – United States Free Trade Agreement provides that:

> (b) Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.

One may notice the low nexus threshold of this clause ("designed and applied") and the condition only that measures be "non-discriminatory".[195] Some expropriation annexes are more detailed. Annex 12 of the Agreement between Australia and Japan for an Economic Partnership (JAEPA) characterises the "rare circumstances" in which a measure will constitute an indirect expropriation, namely, when it "is so severe in light of its purpose that it cannot be reasonably viewed as having been applied in good faith".[196]

Keene argues that because expropriation annexes have more permissive requirements than exception clauses, the only potential chance for exception clauses to actually save a measure failing to fulfil a "right to regulate"

192 *Pope and Talbot*, above n 88, at [78].

193 *SD Myers v Canada*, above n 46, at [246].

194 *GAMI Investments Inc v Mexico (Final Award)* (15 November 2004) W Michael Reisman, Julio Lacarte Muró and Jan Paulsson, Italaw <www.italaw.com> at [114].

195 Amelia Keene "The Incorporation and Interpretation of WTO-Style Environmental Exceptions in International Investment Agreements" (2017) 18 The Journal of World Investment & Trade 62 at 85.

196 JAEPA, above n 101, Annex 12(4).

expropriation annex could be where the "rare circumstances" exist.[197] She notes, moreover, that where such "rare circumstances" are concerned with bad faith, as in the JAEPA, a measure failing at this point would be unlikely to satisfy an exception clause's chapeau.[198] If the "rare circumstances" requirement is seen as encompassing the JAEPA formulation, however, an approach which tribunals could take, this introduces a proportionality *stricto sensu* test for good faith which differs from this paper's recommended chapeau analysis. A measure could conceivably satisfy the necessity test and be undertaken without a protectionist ulterior motive, thus fulfilling the recommended clause's requirements, despite what a tribunal may perceive as a severely disproportionate treatment of interests. Therefore, to include both an expropriation annex and an exception clause covering expropriation would not be pointless.

(c) Other clauses permitting derogations

Certain clauses permit specific derogations from states' obligations. An example is found in clauses ensuring investors' right to transfer funds internationally.[199] This can, *inter alia*, enable investors to properly benefit from their investment(s) by sending profits overseas.[200] In recognition of states' opposing interests in administering their currency and foreign reserves and preventing capital flight and subsequent financial instability, many IIAs enable states to restrict this right in certain circumstances,[201] such as during balance-of-payments crises.[202] Such specific restriction provisions would not necessarily conflict with a general exception clause; a state may fail to meet the specific requirements under such clauses, but could still justify a derogation as being necessary to achieve a different, genuinely held, legitimate objective.

2 Difficulties with justifying certain obligations under exception clauses

Concerns have been raised regarding whether, and the extent to which, the FET and expropriation standards in particular can or should ever be justified under a general exception clause.

Newcombe argues that a breach of FET is unlikely to be justifiable under a general exception clause because a measure meeting such a clause's "stringent

197 Keene, above n 195, at 85.

198 At 85.

199 See, for example, Agreement between the Government of the Republic of India and the Government of the Republic of Bulgaria for the Promotion and Protection of Investments (signed 29 October 1998, entered into force 23 September 1999), art 7.

200 Kolo and Wälde, above n 111, at 161.

201 Dolzer and Schreuer, above n 8, at 215–216.

202 See, for example, Agreement between the Government of Australia and the Government of the United Mexican States on the Promotion and Reciprocal Protection of Investments (signed 23 August 2005, entered into force 21 July 2007), art 9(4).

requirements … including the chapeau analysis" is unlikely to "have violated fair and equitable treatment in the first place".[203] Similarly, Vandevelde considers it "hard to see how a bona fide [public policy] measure would ever violate the obligation of reasonableness embodied" by FET.[204] However, a breach of FET does not necessarily require bad faith on a state's part.[205] Some forms of breaches of FET will likely remain justifiable, such as breaches of investors' legitimate expectations.[206] A measure could *prima facie* constitute such a breach, through entirely changing the legal position and/or assurances on which an investor(s) based their investment(s), whilst simultaneously representing the least investment-restrictive means of achieving a state's desired level of protection of a legitimate objective and not being motivated by any ulterior protectionist purpose.

Given that FET is a vague and highly variable standard,[207] it makes no sense to exclude it from the scope of exception clauses in all IIAs, where certain breaches of FET could fulfil the requirements of the recommended exception clause. FET could arguably be excluded from the scope of exception clauses in treaties formulating FET along the lines of CETA, which provides an exhaustive list of breaches of FET including only denial of justice, breaches of due process, "manifest arbitrariness", targeted discrimination and "abusive treatment of investors".[208] These forms of breaches, which are generally unreasonable in nature, would almost certainly fail to satisfy the necessity and/or chapeau test under the recommended exception clause, and would not deserve justification anyway. Where an IIA does not restrict breaches of FET to these more unreasonable or unfair forms of treatment, however, FET should remain within the scope of its exception clause.

Newcombe also argues that if expropriation falls within an exception clause's scope, the state's obligation to pay compensation should remain, since IIAs should not "provide less protection to foreign investors than that accorded under customary international law".[209] However, an IIA which provides for ISDS, regardless of the strength of its substantive protections, will almost certainly provide investors with more protection than customary international law, due to the relative inaccessibility of adequate remedies under customary international law. This is a dangerous argument which could be used to justify all sorts of reductions in investment protection

203 Newcombe, above n 187, at 11.

204 Vandevelde, above n 82, at 458–459.

205 See for example, *Tecmed Award*, above n 53, at [153]; *CMS v Argentina Award*, above n 6, at [280].

206 Legum and Petculescu, above n 118, at 356.

207 Dolzer and Schreuer, above n 8, at 160–161.

208 Art 8.10.

209 Andrew Newcombe "General Exceptions in International Investment Agreements" in Marie-Claire Cordonier Segger, Markus W Gehring and Andrew Newcombe (eds) *Sustainable Development in World Investment Law* (Kluwer Law International, Alphen aan den Rijn, 2011) at 369.

under an IIA, but it is worth recalling states' interest in not pursuing blanket reductions in investment protection anyway (which would harm their own investors, and cause foreign investors in their territory to seek higher returns). In contrast to other types of reductions in investment protection, however, permitting expropriation without compensation to be justified will likely barely reduce investment protection in practice. This is because measures so severe in their effect as to amount to expropriation (essentially involving a severe loss of control, or ability to enjoy the use, of an investor's property),[210] for which the investor(s) is not compensated, will very rarely satisfy the least-restrictive-means test and also involve no ulterior protectionist objective. Such a scenario is not entirely unthinkable, however, in which case a state should not be discouraged from regulating as necessary to achieve a legitimate objective (due, for example, to the costs of compensating an investor being prohibitive). Expropriation without the payment of compensation should thus be justifiable in principle under an exception clause, even if it is unlikely to fulfil the clause's requirements in the vast majority of contexts.

IV. Conclusion

It is helpful to construct a model exception clause whose design reflects the foregoing discussion. It should be noted that the permissible objectives in the model clause provided only exemplify the detail with which listed objectives should be defined, rather than the actual policy areas which should be included. Additionally, the clause's footnotes are to be read as integral to the clause. The clause should read as follows:

> Provided that such measures are not ultimately intended as a restriction on international investment,[211] nothing in this Agreement shall be construed to prevent a Party from adopting or enforcing measures necessary[212]

210 Dolzer and Schreuer, above n 8, at 138; Caroline Henckels "Protecting Regulatory Autonomy through Greater Precision in Investment Treaties: The TPP, CETA, and TTIP" (2016) 19 J Intl Econ L 27 at 40.

211 A measure is "ultimately intended as a restriction on international investment" where any motive of restricting international investment as an end in itself can be discerned through an examination of the wider circumstances in which a state adopted a measure, such as a state's broader legislative regime and conduct, and the domestic context in which the measure was adopted. A tribunal may not weigh an objective's importance against a measure's effect on international investment in order to discern this ultimate intention.

212 A measure is "necessary" where the claimant cannot establish the existence of another reasonably available measure which contributes, or is apt to contribute, equally or to a greater extent to the Party's chosen level of protection of a legitimate objective while having a less restrictive effect on international investment. A measure is "reasonably available" only where a Party is genuinely capable of taking it.

> to achieve a legitimate[213] objective, including, but not limited to:
>
> a) The protection of public morals;[214]
> b) The protection of public order;[215]
> c) The protection of the environment;

The model clause is designed with the intention of properly balancing the competing interests under IIAs, whilst ensuring greater certainty in their application, aims which should interest all stakeholders in international investment law. Considerations of sovereignty, and the need to combat regulatory chill, clearly support better preserving states' right to regulate under IIAs, in light of the severe threat posed by IIAs to states' regulatory autonomy and the glaring deficiencies of current 'right to regulate' approaches. Particular advantages of the recommended clause, from this perspective, are that it limits tribunals' discretion wherever possible, and in particular the discretion of tribunals to override states' prioritisation of policy objectives. Investors and predominantly capital-exporting states should also have an interest in including an exception clause along the lines of the suggested model within IIAs, as this represents one of the rare methods of reform which will assuage most states' fears regarding regulatory autonomy whilst also limiting the protection of foreign investors only in circumstances when, and to the extent that, this is genuinely necessary for the achievement of a legitimate objective.

The clause's list of permissible objectives is non-exhaustive, because states' flexibility to respond to unexpected contingencies and set their own regulatory priorities must be maintained. The legitimacy of non-listed objectives is easily established for similar reasons. The legitimacy of listed objectives is unquestionable, but states should still describe such objectives sufficiently clearly to remove any doubt that their regulatory priorities are covered.

A "necessary" nexus link is used for all permissible objectives, defined as entailing a least-restrictive-means test. This appropriately enables states only to interfere with foreign investments to the degree actually required for achieving a legitimate objective. A state can therefore feel relatively secure in regulating towards a public good where it has endeavoured to minimise the impact of such regulation on investors, as should be the case. The exclusion of any 'weighing and balancing' removes the uncertainty inherent in asking tribunals to make subjective assessments about the value of non-investment

213 All listed objectives are accepted by the Parties to be legitimate. A non-listed objective is "legitimate" if a Party can establish that some benefit can reasonably expected to derive from it and that its objective is not to breach of any provision of this Agreement.

214 "Public morals" constitute the standards of right and wrong conduct maintained by or on behalf of a community or nation.

215 "The protection of public order" includes the preservation of peace and the repression of illegal actions and disturbances which threaten the legal order.

interests, whilst also preventing tribunals from overriding a state's own regulatory priorities.

The clause excludes self-judging language because the nature of 'good faith' review of the clause could vary significantly, from approaches which add little to a state's right to regulate anyway, to approaches which afford states far too much deference at investors' expense.

The recommended chapeau is intended to catch out measures which should not find justification under an exception clause, but which may nonetheless satisfy the clause's other requirements. Accordingly, the chapeau seeks to ascertain whether a measure's ulterior motive is to restrict international investment, regardless of whether this may exist alongside a legitimate objective. To exclude measures with such ulterior motives may seem excessive if they have already been found "necessary" to achieve a legitimate public policy objective. However, the international investment system must never tolerate measures ultimately aimed at breaching its own rules. Moreover, because it is largely the state itself which dictates the limits of the model clause's necessity test, it is necessary to combat abuse of the clause. Measures adopted with an ulterior protectionist motive should therefore never be justified. Such a motive may be ascertained by holistically examining the wider context in which a measure was adopted. Although this leaves an unfortunate amount of discretion to tribunals, the importance of ascertaining such an ulterior objective (or a lack thereof), and the impracticability of creating a more rigid test for doing so, renders this a necessary evil.

Finally, the model clause is general in scope. It would ultimately be desirable for the analysis under the model clause to replace tribunals' existing 'right to regulate' approaches. The clause is carefully designed to preserve states' right to regulate in the public interest while obliging states also to minimise a measure's investment-restrictive effect in order to achieve justification. The proportionality *stricto sensu* approaches undertaken by tribunals regarding breaches of FET and indirect expropriation can unduly undermine states' regulatory autonomy, whereas tribunals' lenient approaches to national treatment shift unnecessary risk to foreign investors. The clause's requirements are sufficiently unique to enable a measure failing to fulfil the requirements of an expropriation annex or even a more specific 'right to derogate' clause to still find justification under the general exception clause. Moreover, difficulties regarding the nature of FET and indirect expropriation do not generally justify excluding these standards from exception clauses' scope, though in regard to FET, this may depend on its particular nature under an IIA.