Chapter 3

The Laws Governing Foreign Investments: Getting the Relationships Right

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For any foreign investment, there are potentially three 'sources' of law that may apply to the investor and its investment in the host state.[1] This chapter looks briefly at the appropriate relationships between these three different sources of law:

- domestic law, including elements such as tax law, labour law, zoning law, environmental law, and consumer protection laws;
- contracts between an investor and the national government of the host state (or subnational governments in some jurisdictions); and
- investment treaties concluded between the host state where the investment is located and the home state of the investor, when such a treaty applies.

Whether the contracts between an investor and the host government are a true 'source' of law or spring from national law as the source of law is a theoretical question somewhat beyond the necessary scope of this Resource. For our purposes we note that such contracts, which are the main subject of this Resource, possess important qualities which can have major impacts on their functioning inside or outside the national legal system of the host state. These key qualities include a status as 'international contracts' that often also attracts international law as a source of law; frequent use of international arbitration for disputes; and in many cases the inclusion of provisions designed to displace and replace normally applicable law with the negotiated provisions in the contract. In some cases, the contracts are enacted into legislation by national legislatures, or pre-defined as being of a special legal status that allows them to include provisions contrary to the normally applicable law. In many instances, the contracts are not even governed by the national law of the host state but by another national law imposed by the investor as part of the negotiations (often English or French law). All of these issues make contracts

between foreign investors and host governments different from normal domestic-only contracts, and potentially elevate the role of the contract under international law. Investment contracts involving developing countries tend to have more of the characteristics described in this paragraph.

For present purposes, it is sufficient to note that these contracts can contain some of, and in some cases most of, the critical obligations and rights of the governments and investors who negotiate them. Hence, understanding how they fit in the relationship as a part of the law governing the investment is crucial to determining, in the context of a specific negotiation, the role they should play in relation to a planned investment.

In the most positive situation, the legal provisions regulating any investment should come primarily from the applicable domestic law. This is certainly the prevailing situation in developed countries, but is less the case in developing countries that turn more often to extensive contracts. Where the domestic law of the host state is fully developed and applied, this will significantly reduce the scope for negotiations in a contract. Where the domestic law provides the bulk of the legal regime, the contracts will provide the specific details for implementing and applying the law to the individual project.

When lawyers are fully engaged in the contracting process, they can ensure the proper relationship between domestic law and the contract is maintained.

Reliance on domestic law will ease the burden on governments during any negotiation, make the rights and obligations of investors more consistent and transparent, ease burdens on enforcement of the applicable law, reduce opportunities for corruption to play a role in the establishment or conduct of the investment, and generally promote a business and legal environment that respects all aspects of domestic law. When lawyers are fully engaged in the contracting process from the beginning, they can ensure the proper relationship between the domestic law and the contract is maintained, and that the contract remains fully consistent with domestic law instead of seeking to displace it.

Generally, governments should be aware of the extent to which contracts between governments and foreign investors displace or replace the law generally applicable to other investors and create a specific legal regime for each particular investor, and be clear about the extent to which contracts will be allowed to deviate from the generally applicable law. In our view, in a perfect world, it is indeed arguable that investment contracts

of the type that create bespoke legal regimes for individual investments would stop being used completely and be replaced with regulatory structures that are supplemented only to the extent needed by the terms of the business deal and related specifics of each project. This would still require negotiation of these specific applications, but it would end the practice of bespoke legal regimes for every investment.

In a well-structured domestic legal regime, applicable investment treaties will apply only to protect investors from egregious government acts with significant impacts on the investment. They will not fill in additional law, as the main law will come from the applicable domestic law, supplemented by the contract or permit. As noted by the Commonwealth Secretariat[2] among others, investment treaties will contain generalised provisions such as a requirement of fair and equitable treatment of investors or non-discrimination between investors. The treaties usually add a layer of dispute settlement as well. IIAs are often tilted in favour of investor rights and rarely incorporate significant investor obligations. As a result, they can constrain future policy space and risk creating regulatory chill for governments that seek to improve their regulatory regimes. There have also been instances where international investment treaties raise potential barriers to the application of other international law obligations by governments, such as in relation to the environment (see, e.g., the discussion on climate change below) or Indigenous People's rights, and others. To ensure these barriers do not arise, it is important for governments to reflect their international obligations as much as possible in their domestic legal regime.

Figure 3.1 The relationship between sources of law, right way and wrong way

What is important to note is that the impact of investment treaties on regulating how specific investments perform in relation to environmental, social and economic development obligations will at best be minimal when the domestic law regime is well developed. For legal regimes where the domestic law is not well developed, we often see the inverse pyramid (see Figure 3.1).

In these circumstances, investors and governments attempt to buttress the absence of domestic legal provisions with the contents of the contract. Indeed, in many instances, investors will seek to use the contract to displace the local law with a new, bespoke legal regime just applying to that investment. This can include taxation, employment, land acquisition, environmental issues, and other areas of law. Such negotiations will inevitably lead to unbalanced contracts, especially when government negotiating teams are not as skilled or experienced as the company lawyers and negotiators.

In this situation, investment treaties can lead to even more imbalance due to the restriction on policy space many treaties bring with them. In particular, it often becomes especially hard to put in place new laws of general application that will apply to the investment when a contract has been used to displace the domestic law in whole or in part. And the additional layer of dispute settlement that the treaties enable enhances the risks governments face in seeking to improve their domestic law. Indeed, in the event of a dispute, the treaty in this inverse relationship will work to reinforce the imbalance in rights and obligations that often comes with the contract developed in this context due to the imbalance in the treaty with its investor rights and absence of obligations.

Including provisions that are contrary to domestic law degrades domestic law and creates a business and legal environment that risks a lack of respect for it.

In summary, the inverse pyramid creates several risks to the role of domestic law in managing any FDI project. The practice of including provisions that are contrary to domestic law degrades domestic law and creates a business and legal environment that risks a lack of respect for domestic law, and hence respect for the rule of law. IIAs can also contribute to such an environment of less respect for domestic law. And yet domestic law should be the most important source of law for managing foreign as well as domestic investment. As for the rights of the population at large, there is no source of law other than domestic law that would protect them. There is no short-term fix for this

problem, but one thing governments can do is to work to prevent domestic law from being hollowed out in contracts. This Resource supports the role of government lawyers in reflecting domestic law in contracts.

These issues are discussed further in Section 5.4 on Applicable Law.

Notes

1 A full discussion of this can be found in Selacuse, Jeswald (2013), *The Three Laws of International Investment,* Oxford University Press.

2 Commonwealth Secretariat (2013), *Integrating Sustainable Development into International Investment Agreements: A Guide for Developing Country Negotiators.*