Rebalancing through Exceptions

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One commonly proposed method of rebalancing bilateral investment treaties (BITs) is through the use of exceptions, whether general or special. General exceptions apply to all of the obligations of the BIT, while special exceptions apply only to a limited number of BIT obligations.

Several general exceptions already appear in the BITs of multiple countries. The most common is an exception for measures necessary to protect a party's essential security interests. Other general exceptions include those that apply to measures to protect human, animal and plant life and health, environmental measures, measures to preserve public order, measures to fulfill a party's obligations with respect to the maintenance of international peace and security, measures with respect to financial services taken for prudential reasons, measures related to monetary or exchange rate policies, measures of taxation and measures to promote cultural or linguistic diversity.

Although it is not exhaustive, the list reflects the fact that most general treaty exceptions in BITs address one of four basic concerns, broadly defined: the security of the state against external threats or internal disorder, the preservation and protection of life (including the physical environment that makes life possible), the regulation of the economy, and the preservation of diverse cultures.

Many BITs also include special exceptions. The most common special exceptions apply to the national and most favored nation treatment provisions of the BITs. These exceptions usually are for measures enacted pursuant to a party's obligations under a customs union or free trade area and for taxation measures. Those BITs that include an obligation of national and MFN treatment with respect to the establishment of investment typically exclude certain sectors of the economy from the obligation. Many BITs include an exception to the requirement of free transfers of payments related to an investment that allows exchange controls when foreign exchange reserves fall to very low levels.

In recent years, one can discern at least two trends with respect to exceptions. First, although I have collected no data, BITs quite evidently now include greater numbers of exceptions than in the more distant past. Further, special exceptions, when they appear, apply to larger numbers of treaty obligations. To some extent, the trend merely reflects the fact that more countries are adopting exceptions that have been in use for many years. In some cases, however, new exceptions are emerging. These include, for example, exceptions for environmental measures and exceptions for regulating for the financial services sector.

As this suggests, countries already are engaged in rebalancing through treaty exceptions, though it is important to note that, even with the trends I have described, an empirical survey surely would reveal that a majority of BITs do not yet contain any general exceptions, although the special exceptions applicable to the national and most favored nation treatment provisions are extremely common. Those who wish to rebalance BITs through treaty exceptions still have much work to do.

A second trend has been toward the practice of inserting so-called "self-judging" language into the exceptions, especially the essential security interests exception. Such language typically provides that nothing in the treaty shall be construed to preclude a party from taking measures "it deems necessary" to protect its essential security interests. The effect of this language may be to render nonjusticiable a party's invocation of the essential security interests exception. At a minimum, it requires a tribunal to give great deference to a party's invocation of the exception.

The remainder of my comments today will be directed at these two trends. I will discuss them in reverse order.

I. Self-Judging Language in Treaty Exceptions

Self-judging language originated during the negotiation of the charter of the International Trade Organization in Geneva in 1947. At the behest of the United States, the Havana Conference on Trade and Employment incorporated into the proposed ITO Charter a general exception under which nothing in the charter was to be construed to prevent a member from taking any action which it considers necessary for the protection

of its essential security interests, where such action relates to fissionable materials, to traffic in implements of war or to traffic in goods or services for supplying a military establishment, or taken in time of war or other emergency in international relations. The same language would be incorporated into the General Agreement on Tariffs and Trade (GATT).

Although this language often is described as if it were entirely self-judging, in fact that appears not to have been the intent of the United States. My research into the negotiating history of the exception indicates that the United States intended that the ITO would have jurisdiction to determine whether the measures related to fissionable materials, traffic in implements of war, or traffic in goods or services to supply a military establishment or were taken in time of war or other international emergency. The only aspect of the exception that was to be self-judging was the issue of whether the measures were necessary. During the meetings of the U.S. delegation, representatives of the armed forces strenuously argued that the exception should be revised to indicate that each party was the sole judge of all aspects of the applicability of the exception. This argument was resisted by most of the rest of the delegation and did not prevail. U.S. negotiators feared that other countries would use an entirely self-judging exception to evade their responsibilities under the charter, which was a U.S. initiative. They recognized that to allow any party to be the sole judge of its own compliance with the charter would negate the effect of the charter as law. The heated debate over this issue within the U.S. delegation demonstrates that the delegates understood that the self-judging language altered the meaning of the exception. The language did more than merely confirm a meaning that the language would have had in any event.

The United States also included a security interests exception in its post-war friendship, commerce and navigation (FCN) treaties, which were the progenitors of the BITs, but that exception omitted the self-judging language. Self-judging language had never appeared in U.S. FCN treaties in the past and I can find no evidence that anyone at the State Department wished to insert it in the wake of the ITO and GATT negotiations. The United States did, however, omit from the essential security interests exception in the FCN treaties the various qualifying conditions found in the ITO charter and the GATT, such as that the measures be taken in time of national emergency. FCN treaties concluded

prior to the ITO charter negotiations generally limited the applicability of their national security exception to times of national emergency. After the Havana conference, the United States removed the qualification. Thus, the exception in the FCN treaties concluded after the Havana conference was broader than that in the ITO charter and the GATT (because it was not limited to emergency situations), but it did not include the self-judging language and thus its invocation was entirely subject to review under the compromissory clause of the treaties. When it inaugurated its BIT program in 1977, the United States also included an essential security interests exception and that exception foll0wed very closely the language in the FCN treaties. Thus, the U.S. BITs adhered to the approached used in its FCN treaties, rather than in the ITO charter and the GATT.

The United States would reconsider its traditional position in 1984, when Nicaragua filed a claim against the United States before the International Court of Justice alleging that U.S. support for paramilitary forces engaged in hostilities against the Nicaraguan government violated the FCN treaty between the two countries. The United States pleaded the essential security interests exception as a defense and argued that the exception was self-judging, despite the absence of the self-judging language. The court rejected the U.S. argument, however. During the 1990s, the United States declared publicly that, despite the ICJ ruling, it regarded the BIT exception as self-judging and in 1998 it modified its model BIT to include the self-judging language. A few other countries have begun to include self-judging language as well, although generally only in the essential security interests exception.

As is well known, Argentina has pleaded the essential security interests exception as a defense in a number of claims submitted to investor-state arbitration arising out of its financial crisis at the turn of the century. Argentina has argued that certain measures that it took to address the crisis, but that diminished the value of foreign investment, were measures necessary to protect its essential security interests and, therefore, cannot violate the obligations of the BIT. Argentina has also argued that the exception is self-judging, but all of the tribunals to have considered that argument have rejected it on the ground that the BIT between Argentina and the United States lacks the self-judging language.

Argentina's argument regarding the self-judging nature of the exception rested on the fact that, by the time the claims were filed, the United States had declared publicly

that it regarded the essential security interests exception to be self-judging. Argentina contended that, inasmuch as both parties to the treaty regarded the language as self-judging, the language must be self-judging. Argentina, however, was never able to produce any *travaux preparatoire* demonstrating that during the negotiations the parties agreed that the exception was self-judging. Moreover, Argentina's understanding of the concept of "self-judging" is that a state's invocation of the exception was subject to an obligation of good faith, while the understanding of the United States is that a state's invocation of the exception rendered the dispute nonjusticiable. Thus, even on Argentina's account, the two treaty parties have attached special meanings to the language that are different. Despite the fact that the two parties both used the phrase "self-judging," the two parties were not in accord.

The question of which country's interpretation of the phrase "self-judging" is correct remains unanswered. The slow proliferation of treaties with self-judging language thus is particularly disturbing in the absence of a consensus about what it means for an exception to be self-judging.

II. The Proliferation of Treaty Exceptions

The proliferation of treaty exceptions reflects to some degree a desire to rebalance treaty obligations by adjusting their scope. While the addition of new exceptions does in a sense rebalance the treaty as a whole, the effect of a treaty exception in relation to any specific treaty obligation is not to counterbalance the obligation, but to overbalance it. That is, whenever an exception applies, a treaty obligation is not simply weakened, but extinguished. Thus, where a party pleads an exception as a defense to a claim that a treaty obligation has been violated, the only benefit that a foreign investor may receive from that obligation is the right to have an arbitral tribunal determine whether the exception does, in fact, apply.

Where the exception is self-judging, then the treaty may not provide even that benefit. In fact, it can be argued that, if a self-judging exception is not subject to an obligation of good faith, then its presence renders treaty obligations illusory. If we care about the obligations of the treaty, then treaty exceptions should be employed carefully.

Although this might suggest that those who favor strong BITs should regard them uniformly as highly undesirable derogations from desirable BIT obligations, such a view would be an oversimplification. Exceptions can actually promote BIT obligations in at least two ways.

First, in some cases they may make it possible for a country to accept BIT obligations that it otherwise could not accept. For example, a country with low foreign exchange reserves might be unwilling to conclude a BIT unless the treaty includes an exception allowing exchange controls in emergency situations. The limited exception preserves for that state the discretion that it needs and enables it to accept other BIT obligations.

Second, in the absence of an exception, a country facing difficulty complying with an obligation under a particular set of circumstances may be tempted to give a strained construction to a BIT obligation in order to preserve its freedom to act in that set of circumstances. Strained, or counterintuitive, treaty interpretations undermine the security and transparency that BITs are intended to create. A well-crafted exception with limiting safeguards may provide a country with the necessary freedom, while giving investors notice of the possibility of a derogation from general BIT norms and placing limits on the derogation, such as that it be on a nondiscriminatory basis, that preserve at least some BIT principles even during the special circumstances of the exception. Every exception, in other words, does not necessary represent a complete defeat for investor interests. An exception may represent a calculated concession that makes possible a more favorable investment climate than would otherwise exist.

We can perhaps gain some practical appreciation of these kinds of very general remarks by examining the specific case of the role of the essential security interests exception in recent investor-state arbitrations. This is the only exception to have been the subject of extensive discussion by investor-state arbitral tribunals and thus it is by default the best example of how exceptions might work in practice.

Let us begin by noting that the essential security interests exception in the U.S.-Argentina BIT was not a concession extracted by the capital importing state from the capital exporting state as a condition of providing investor protection. The essential security interests exception was one proposed by the United States in its model BIT.

Argentina does not as a matter of practice demand the inclusion of a national security exception. So, the exception represents a situation in which the United States regarded its national security as more important than the protection of foreign investors. National security, in other words, overbalanced investor protection. Where the two interests collided, a country's national security interests would prevail.

Second, Argentina's threshold problem was to persuade the tribunals that the exception applied to measures taken during an economic crisis. Although the plain language of the exception does not foreclose such an interpretation, the history of the exception suggests that it the drafters did not contemplate its application to economic crises. During the ITO charter negotiations, the United States proposed an elaborate exception in which the circumstances to which the exception applied were specified in greater detail. The various circumstances, such as trade in fissionable materials or trade in armaments, all appeared to be related to military security. After the Havana conference, the United States simplified the exception in its FCN treaties by removing the various qualifying conditions, but I have seen no evidence that the purpose of this change was to broaden its application to include economic crises.

In fact, the history may suggest the contrary. The late 1940s were a period of great economic distress. At the end of the war, only the U.S. dollar was a freely convertible currency. The ITO negotiations were occurring in the wake of a very severe winter that inflicted enormous suffering on Europe and that triggered the Marshall Plan for economic recovery in Europe. The United States was well aware of economic problems such as shortages of foreign exchange and it sought to address them with language in the FCN treaties that left states with discretion to address their economic concerns. More specifically, the U.S. model FCN treaty included a balance of payments exception allowing a country to derogate from its obligation to permit free transfers during times when foreign exchange reserves were low. Moreover, national treatment obligations with respect to the establishment of investment were hedged with exceptions. In this way, the United States allowed its treaty partners a measure of discretion to address economic difficulties associated with international capital movements. In other words, the United States recognized the problem of economic crises and crafted specific language to address those crises. Over the years, the United States decided to agree to

fewer such exceptions, but I find no indication that decision rested on the belief that such exceptions were redundant of the essential security interests exception.

In any event, all of the tribunals that have addressed the issue have accepted Argentina's argument that measures to protect a party's essential security interests could include measures addressing economic crises. Unlike the exceptions typically crafted for economic crises, however, the essential security interests exception provides little guidance regarding the circumstances to which it applies and includes no limiting safeguards. It is an exception that overbalances all BIT obligations when it applies and the scope of its application is not carefully defined.

Perhaps for these reasons, tribunals have been reluctant to accept Argentina's argument that its measures were necessary to protect its essential security interests. The tribunals accepted the claim that Argentina's essential security interests were at stake, but then carefully scrutinized the question of whether the measures taken were necessary, concluding in most instances that they were not.

This suggests the need for carefully crafted exceptions. Faced with a large number of claims, Argentina sought refuge in a broad reading of the essential security interests exception, arguing both that the exception applied and that it was self-judging. If it decided that the exception applied, the tribunal would have immunized Argentina from any responsibility under the treaty. Far preferable would have been a more carefully crafted exception that addressed economic crises explicitly and incorporated limiting safeguards into the exception that preserved at least some BIT principles.

III. Conclusion

The careful crafting of exceptions is particularly important given the nature of BIT obligations. I have argued elsewhere that BITs are founded on six principles – security, reasonableness, nondiscrimination, transparency, due process and access. I have further argued that the first five of these principles – that is, security, reasonableness, nondiscrimination, transparency and due process – are elements of the rule of law. To my mind, the primary purpose of a BIT is to ensure that foreign investment is treated in accordance with the rule of law. For this reason, self-judging exceptions are especially

troubling. A provision that exempts treaty provisions from the judicial or arbitral process is very difficult to reconcile with a treaty intended to establish the rule of law.

Further, to the extent that the BITs are instruments of the rule of law, then it seems doubtful, at least to me, that having a large number of general exceptions is necessary or desirable. Consider an exception for environmental measures, for example. It is hard to see how a bona fide environmental measure would ever violate the obligation of reasonableness embodied in the fair and equitable treatment provision. Nor is it easy to see why a state seeking to protect the environment would ever need to violate a requirement of due process. When the *Methanex* claim was submitted against the United States in the 1990s, many environmentalists were concerned that environmental regulation at issue in that case would be treated as an indirect expropriation and the expropriation provision has remained an especially controversial part of the BITs. Yet, Methanex lost that claim spectacularly and the fears of the environmental community largely have not been realized. Properly understood, the expropriation provision has a scope no greater than that of the takings clause of the United States Constitution and that clause has not prevented the United States from enacting a robust body of environmental law. In short, the rule of law is not the enemy of the environmental movement. If BITs are interpreted as they should be interpreted, there is very little in them that would impede the protection of the environment.

BITs also include provisions that go beyond the establishment of the rule of law and that open borders to international capital movements. These provisions present different concerns and they may demand exceptions to preserve for the host state the discretion to control inward capital movements or to restrict transfers of capital out of the territory, particularly during a financial crisis. Such exceptions, however, need not be general treaty exceptions but can be special exceptions that address only those provisions that require the parties to permit capital movements.

Rather than incorporating numerous new general exceptions, I would focus attention on promoting the proper interpretation of the BITs' provisions. Where exceptions are needed, they are most likely to be special exceptions that are directed at provisions relating to capital movements or exceptions that address extraordinary circumstances, such as a threat to national security. But bona fide, nondiscriminatory

legislation for the public welfare adopted and applied in a manner that is transparent, nonconfiscatory, consistent with the state's prior commitments and in accordance with due process of law should rarely require a BIT exception.