

# China's Engagement in ISDS Reform: Text, Practice, and Political Economy

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*The investor-state dispute settlement (ISDS) system is such a means to an end of further economic development and wider social political goals. With major protective provisions of expropriation against compensation, fair and equitable treatment, national treatment, most-favored-nation treatment, full protection and security and umbrella clause, it helps establish a predictable, transparent, and enforceable legal regime to protect foreign investors' legitimate expectations and lawful investment. As China intends to attract foreign investments by offering a stable business operation environment, its signing a large number of BITs and FTAs may help reduce political and socio-economic risks, which give states, businesses, and individuals the confidence to work in a coordinated manner. The economic development goal, rule of law strategy, tense US-China relations, ideology of multilateralism and community of common destiny, all add up to China's inclination to incremental but effective ISDS reform.*

**Keywords:** ISDS, ISDS Reform, BIT, International Investment Arbitration, Political Economy

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## I. INTRODUCTION

Investor-state dispute settlement (ISDS) is a mechanism that allows an investor from one country to bring arbitral proceedings directly against another country in which it has invested.<sup>1</sup> The mechanism is typically set in bilateral or multilateral investment treaties, free trade agreements (FTAs), and national foreign investment laws. It seeks to promote foreign investment by giving investors clear expectations and a fair process for dispute resolution. Although ISDS strives to provide impartial decisions about investment disputes, there are increasing debates about its legitimacy and calls for reform.

Criticisms against ISDS include the exposure of host states to additional legal and financial risks,<sup>2</sup> pro-investor interpretation of the investment treaty,<sup>3</sup> regulatory chill,<sup>4</sup> frivolous or unmeritorious claims,<sup>5</sup> inconsistency and unpredictability of decisions,<sup>6</sup> lack of transparency,<sup>7</sup> bypassing of the national judicial system,<sup>8</sup> partial and self-interested arbitrators,<sup>9</sup> long duration and high costs,<sup>10</sup> third-party funding, and inadequate due process in the multi-layered proceedings.<sup>11</sup>

These problems have led to different proposals for reforming the ISDS system, for the purpose of specifically correcting perceived deficiencies.<sup>12</sup> These include better guidance mechanisms for arbitral tribunals, improving the code of conduct for arbitrators and rules on third-party funding, creating a roster of tenured judges, and introducing an appellate body or fully-fledged multilateral investment court.<sup>13</sup> However, these possible solutions may only further entrench and institutionalize the ISDS system, leaving its structural problems and injustices intact.

Political economy—the study of how politics and economy influence international policy-making—can help legislators revise arbitration rules to more accurately capture a state's preferences, thereby giving states greater autonomy. Ultimately, challenges for the existing ISDS system are rooted in the fundamental political trilemma of globalization, so that we cannot simultaneously pursue democracy, national determination, and economic globalization.<sup>14</sup> As democracy would protect social arrangements, re-empowering national democracies will place the world economy on a safer, healthier footing. Should we prefer a thinner layer of international injustice that leaves substantial room for maneuver by national governments?

This article uses political economy as a theoretical framework to illustrate

China's engagement in the ISDS reform and more generally to discuss the impact of ISDS on global governance for sustainable and inclusive development. The rest of this article proceeds as follows. Part two will examine how political economy and ideology variation lead to considerable resistance to the current ISDS system due to its procedural and substantive illegitimacy problems; controversial spillover effects on environmental, socio-economic, and other regulatory issues; and the difficulty of resolving the ultimate political trilemma of the world economy. This section reveals that the legitimacy crisis of ISDS is essentially attributable to the conflict between national sovereignty, democracy, and globalization. Part three will present solutions to these problems, including incremental ISDS reform and radical alternatives such as an MIC, and discusses their feasibilities. Some lessons are drawn from the World Trade Organization (WTO)'s dispute settlement body (DSB) system. Part four will investigate China's ISDS involvement in both treaty-making and investment arbitration cases, aiming to map China's evolving attitude and actions in different historical contexts. As conclusion, Part five will rethink the political economy functions of the ISDS system and suggest that China is committed to coordinating with other countries in pursuit of economic development and common interests in a shared future.

## **II. CHINA'S INVOLVEMENT IN ISDS: TEXT EVOLUTION**

### **A. Three Generations of Chinese Bilateral Investment Treaties in the Past Four Decades**

Over the past 25 years, China has signed over 120 BITs, which ranks second to Germany in the numbers of BITs concluded.<sup>15</sup> Although China is the largest recipient of foreign direct investment (FDI) among developing economies,<sup>16</sup> it has become a major source of FDI, with significant Chinese investment in Africa and Asia. Since 1998, China's BIT policy has increasingly addressed the protection of Chinese overseas FDI. Beginning with its 1998 BIT with Barbados, China abandoned its practice of limiting investor-state arbitration to disputes concerning the amount of compensation following expropriation, instead of consenting generally to the arbitration of BIT disputes. China's current practice is reflected in its BITs with the Netherlands (2001) and Germany (2003), which provide

substantive and procedural protections for the investor (significantly limited under early Chinese BITs) generally similar to those found in capital-exporting-state BITs. China has also begun to conclude FTAs featuring wide-ranging procedural and substantive investment obligations.

The transitions over three generations of China's BITs are illustrated by the characteristics of the ISDS clauses agreed with the EU Member States between 1982 and 2009.<sup>17</sup> This period witnessed many changes of provisions concerning jurisdiction and substantial protection, while the EU itself underwent enlargement and the exit of members, most significantly the recent withdrawal of Britain. In the meantime, China's BITs have undergone their own evolution in response to changes in economic development, policy orientation, and the global context.<sup>18</sup>

The inaugural generation of China's BITs started with the 1982 BIT with Sweden and ended in the late 1990s.<sup>19</sup> In this timeframe, China negotiated a total of 80 "restrictive" BITs<sup>20</sup> containing important reservations about substantive as well as procedural protections of foreign investment, without national treatment or ISDS clauses. Although China began to consent to some form of international arbitration in 1985, and joined the International Centre for Settlement of Investment Disputes (ICSID) system in 1993, China's early BITs granted only narrow protection to investors. These BITs limited the ICSID's jurisdiction to the amount of compensation due for expropriation or nationalization after the exhaustion of local remedies. These treaties sometimes refer only to the ad hoc arbitral tribunal for dispute settlement despite the widely recognized ICSID and the United Nations Commission on International Trade Law (UNCITRAL) arbitration.<sup>21</sup>

The second generation of Chinese BITs commenced in 1998 when China started to include an ISDS clause comparable to such provisions found in BITs of the Organization for Economic Co-operation and Development (OECD) countries.<sup>22</sup> From 2000, China began to include more national treatment provisions and consent to comprehensive ISDS provisions. This transition is prominently marked by the conclusion of a BIT with the Netherlands in 2001 that unconditionally consents to international arbitration,<sup>23</sup> and the subsequent BIT with Germany in 2003 that primarily conforms to standard practices in over 2,400 BITs worldwide.<sup>24</sup> According to the China-Germany BIT 2003, "any dispute arising out of investment" can be submitted, at the foreign investors' request, to the ICSID

for arbitration, if the dispute cannot be resolved within six months by amicable consultation.<sup>25</sup> Similar provisions could be found in the China-Netherlands BIT 2001.<sup>26</sup>

The third generation of China's investment agreements included both bilateral and regional FTAs, together with a broader scope of FDI industries. China has notably expanded market access to FDI in its areas of interest, which started with revisions of the Catalog for the Guidance of Foreign Investment Industries in 2015 and 2017. Restricted measures to impede FDI have been reduced to 63 items, and only 28 items remain in the prohibited category.<sup>27</sup> On June 28, 2018, China published its first Special Administrative Measures for Foreign Investment Access (also known as "Negative List"), reducing restrictions from 63 to 48 and introducing new opening-up measures in 22 sectors.<sup>28</sup>

In summary, China is increasingly prepared to accept adjudicative methods for dispute settlement instead of diplomatic means,<sup>29</sup> when it considers that the benefits of doing so outweigh the economic and political costs. In the field of international investment arbitration, China has invested immense resources in preparing the country and its investors for future ISDS engagement.<sup>30</sup>

## **B. Underlying Logic**

The development of China's BITs to conform to major aspects of international standards has culminated in the new generation of Chinese BITs with traditional capital-exporting countries,<sup>31</sup> and subsequently with various developing countries. ISDS clauses are more comprehensive on a wide range of jurisdictional issues such as the scope of claims, forum options, domestic administrative review, applicable law, and compensation standard. They have gradually been introduced in a number of China's BITs.<sup>32</sup> In dealing with developing countries, China behaves more like a traditional capital-exporting country by attempting to secure its investments abroad while minimizing the risk of becoming a respondent in ISDS cases.<sup>33</sup> In line with each country's development strategy, investment policy should help establish open, stable, and predictable entry conditions for foreign investment.

In addition to avoiding inter-state conflict, protecting citizens abroad, and signaling to potential investors that the rule of law will be respected, sensible ISDS can potentially impact not only investment flows and economic growth, but

also the overall relationship between countries, especially regarding the rule of law. China is firmly committed to the sound development of worldwide economic and trade relations, pursuing cooperation and mutual benefit of all countries. As the globalization waxes and wanes, China’s policy towards working together with the global community to build a shared future for humankind<sup>34</sup> could be a historic contribution to the development of international law and governance.

Table 1: The Evolution of Chinese BITs (1982–Present)<sup>35</sup>

	<b>Infancy</b>	<b>Proliferation</b>	<b>Re-orientation</b>
<b>Period</b>	1982–1991	1992–2007	2008–Present
<b>Features</b>	<ul style="list-style-type: none"> <li>• Emergence of BITs</li> <li>• Weak protection, restrictive ISDS</li> </ul>	<ul style="list-style-type: none"> <li>• Liberalization of BITs</li> <li>• Enhanced protection and ISDS in BITs</li> </ul>	<ul style="list-style-type: none"> <li>• Shift from BITs to FTAs</li> <li>• Decline in annual BITs</li> <li>• Exit and revision</li> </ul>
<b>Worldwide events</b>	<ul style="list-style-type: none"> <li>• Draft UN Code of Conduct on Transfer of Technology (1974–1985)</li> <li>• OECD Guidelines for Multinational Enterprises (1976)</li> <li>• Multilateral Investment Guarantee Agency Convention (1985)</li> </ul>	<ul style="list-style-type: none"> <li>• World Bank Guidelines for treatment of FDI (1992)</li> <li>• North American Free Trade Agreement (1992)</li> <li>• Asia-Pacific Economic Cooperation Investment Principles (1994)</li> <li>• Energy Charter Treaty (1994)</li> <li>• Draft OECD Multilateral Agreement on Investment (1995–1998)</li> <li>• WTO (1994)</li> <li>• WTO Working Group on Trade and Investment (1996–2003)</li> </ul>	<ul style="list-style-type: none"> <li>• EU Lisbon Treaty (2007)</li> <li>• UN Guiding Principles on Business and Human Rights (2011)</li> <li>• United Nations Conference on Trade and Development (UNCTAD) Investment Policy Framework (2012)</li> <li>• UN Transparency Convention (2014)</li> </ul>
<b>International forces</b>	New International Economic Order	Economic liberalization and globalization	Development paradigm shift
<b>Economic background</b>	<ul style="list-style-type: none"> <li>• Reform and opening-up</li> </ul>	<ul style="list-style-type: none"> <li>• Joined WTO</li> <li>• Factor-driven growth</li> <li>• Openness to investment</li> </ul>	<ul style="list-style-type: none"> <li>• Facilitate cross-border investment</li> <li>• Part of broader economic integration agendas</li> <li>• Efficiency-driven and innovation-driven growth</li> <li>• Sustainable development</li> </ul>

<b>Political values</b>	<ul style="list-style-type: none"> <li>• Four basic principles:<sup>36</sup> <ul style="list-style-type: none"> <li>- The principle of upholding the socialist path</li> <li>- The principle of upholding the people's democratic dictatorship</li> <li>- The principle of upholding the leadership of the Communist Party of China</li> <li>- The principle of upholding Mao Zedong Thought and Marxism–Leninism</li> </ul> </li> <li>• Four-pronged Comprehensive Strategy:<sup>37</sup> <ul style="list-style-type: none"> <li>- Comprehensively build a moderately prosperous society</li> <li>- Comprehensively deepen reform</li> <li>- Comprehensively govern the nation according to law</li> <li>- Comprehensively strictly govern the Party</li> </ul> </li> <li>• Confidence in the path, theory, system, and culture of socialism with Chinese characteristics</li> </ul>
<b>Cultural values</b>	<ul style="list-style-type: none"> <li>• Just cause should be pursued for the common good<sup>38</sup></li> <li>• Peace, development, fairness, justice, democracy, and freedom are common values of mankind, and the lofty goals of the UN<sup>39</sup></li> <li>• Core Socialist Values:<sup>40</sup> <ul style="list-style-type: none"> <li>- National values of prosperity, democracy, civility, and harmony</li> <li>- Social values of freedom, equality, justice, and the rule of law</li> <li>- Individual values of patriotism, dedication, integrity, and friendship</li> </ul> </li> </ul>

### III. CHINA'S PRACTICE

#### A. Chinese Cases under the ISDS

The ISDS system is widely heralded as a model for how international law can manage and mitigate tensions between states amid a changing geopolitical order. As the rise of China changes the global economy in terms of capital flow, supply chain and technology transfer, the ISDS regime is necessary to place an order of the investment and balance socio-economic interests between the host state and investors. Specific attention is paid to four areas in this article: the design and architecture of the investment regime; the patterns of investment treaty formation; the substance of investment treaty provisions; and treaty interpretation.<sup>41</sup> A cursory glance of China's ISDS practice implies optimism about its continuing interest in participating in the regime.

##### 1. Chinese Cases at a Glance

- Chinese Claimants in ICSID Cases

Under the 129 BITs concluded by China to date, Chinese companies have been

the claimants in four cases before the ICSID. The first ICSID arbitration under a China BIT was *Tza Yap Shum v. Republic of Peru*.<sup>42</sup> Tza Yap Shum, a Hong Kong resident with Chinese citizenship, challenged taxes imposed by the Peruvian authorities on his fish flour manufacturing and exporting company.<sup>43</sup> The merits award supported Tza's claim and granted compensation in the sum of USD 786,000 in July 2011.<sup>44</sup> Peru's application for annulment of the award was heard in March 2014; the ICSID Annulment Committee decided not to reverse the merits award.<sup>45</sup>

The second ICSID arbitration under a China BIT was *Ping An Life Insurance Company of China v. Kingdom of Belgium*.<sup>46</sup> Ping An, a major Chinese insurance and financial services company, sought compensation for the USD 2.3 billion write-offs on its investment in Fortis, a Belgian–Dutch financial institution that Belgium bailed out in 2008. The tribunal rejected Ping An's claim due to lack of jurisdiction.<sup>47</sup>

*Beijing Shougang Mining Ltd. Et al. v. Mongolia* is also a case in which Chinese investors brought investment claims into *ad hoc* proceedings administered by the Permanent Court of Arbitration (PCA). The dispute concerned the Mongolian government's cancellation of licenses held by Chinese investors in the *Tumurtei* iron ore mine in 2012. The PCA tribunal declined the jurisdiction for lack of *ratione materiae* under the narrow dispute settlement clause in the China–Mongolia BIT.<sup>48</sup>

In the most recent case–*Sanum Investments Limited v. Lao People's Democratic Republic*,<sup>49</sup> an *ad hoc* UNCITRAL tribunal decided that it did have jurisdiction to hear claims by a Macau entity under the China–Laos BIT. The award was upheld by the Singapore Court of Appeal (SGCA), which found that the China–Laos BIT applies to Macau.<sup>50</sup>

#### • China as Respondent in ICSID Cases

To date, China has only been the respondent in five BIT arbitration cases under the ICSID Convention. The first publicly known investment claim against China was brought by a Malaysian construction and development company in May 2011. The case of *Ekran Berhad v. People's Republic of China* concerned the revocation of a 70-year's lease of 900 hectares of land in Hainan Province from Ekran Berhad's Chinese subsidiary.<sup>51</sup> The arbitration was suspended by agreement one month after

being registered and then discontinued on unknown terms.

In *Ansung Housing Co., Ltd. v. China*,<sup>52</sup> Ansung Housing Co. Ltd. (Ansung), a South Korean property developer, make claims arising out of the provincial government's alleged actions in relation to Ansung's investment in the construction of a golf and country club and luxury condominiums in Sheyang-Xian, Jiangsu province. The tribunal declined the jurisdiction for the reasons that the arbitration was instituted more than three years after Ansung first acquired knowledge of the loss or damage, thus time-barring the claim under Article 9(7) of the China-Korea BIT. The other three cases<sup>53</sup> are still ongoing and at the hearing stage.

## 2. Jurisdictional Objections Raised and Interpretation Methodologies Applied

The usual bases for jurisdictional objections are the definitions of "investor," "investment," and "dispute"; fork-in-the-road provisions; limitation periods; and most-favored-nation (MFN) treatment of procedural rights. These often appear in Chinese BIT cases.

### • Investor and Investment

In *Beijing Shougang Mining Investment Company Ltd. et al. v. Mongolia*, the claimants asserted that they were "qualifying investors" under Article 1(2) of the BIT because they were "economic entities ... established and domiciled in the territory of the People's Republic of China (PRC) in accordance with the PRC's laws."<sup>54</sup> In denying that Beijing Shougang and China Heilongjiang were "agencies" of the Chinese government or exercised "any element of governmental authority,"<sup>55</sup> the claimants emphasized that the BIT does not exclude state-owned enterprises (SOEs) from its definition of qualifying investors.<sup>56</sup> Mongolia defended by arguing that Beijing Shougang and China Heilongjiang fell outside a narrow formulation of "economic entities" under Article 1(2).<sup>57</sup> The tribunal denied jurisdiction by focusing on the "involving" formulation of the scope of disputes and the fork-in-the-road provision, and so did not elaborate on the standing of SOEs under the China-Mongolia BIT.<sup>58</sup>

In *Beijing Urban Construction Group Co. Ltd. (BUCG) v. Yemen*, the respondent argued in arbitration proceedings that BUCG was purely a paid contractor that had to provide a performance guarantee, which did not qualify as an "investment,"<sup>59</sup>

because BUCG failed to register its investment in accordance with the laws and regulations of Yemen.<sup>60</sup> However, BUCG countered that Yemeni law was irrelevant to its claim and that failure to register the investment was not illegal.<sup>61</sup>

The tribunal held that the registration requirement could not be expressly inferred from the BIT, and confirmed that a qualified investment has to satisfy the required elements of investment under both the BIT and the ICSID Convention.<sup>62</sup> In this case, there was an investment both under the ICSID Convention and the BIT<sup>63</sup> because BUCG had made a contribution under the contract for works extending over a substantial time period to Yemen's economic development<sup>64</sup> that clearly exposed it to risks posed by the sovereign power.<sup>65</sup> The tribunal saw BUCG's commitment under a contract being performed in Yemen as explicitly qualifying as an investment:<sup>66</sup> it constituted "claims to any performance having an economic value," not only satisfying the *Salini* test, but also within the meaning of Article 1 of the BIT.<sup>67</sup>

- Fork-in-the-Road Provision

A fork in the road provision drives the investor to choose international investment arbitration or domestic courts when an investment dispute occurs. The key issue is the sphere of disputes acceptable by the tribunal. The phrase "involving the amount of compensation for expropriation" was a heavily contentious issue in *Tza Yap Shum v. Peru*. Under Article 8(3) of the Peru-China BIT, "a dispute involving the amount of compensation for expropriation may be submitted at the request of either party to the international arbitration of the ICSID." Peru interpreted "involving" as meaning "limited to" or "exclusively"; based on such a restrictive interpretation, arbitration could only be used to resolve "disputes related to the determination of the value of the investment," and not for "potentially important matters" such as "whether expropriation has taken place" and "whether any compensation must be paid."<sup>68</sup> Accordingly, Peru argued that Tza's claims fell outside the scope of Article 8(3) of the BIT, so that the tribunal had no jurisdiction to determine if the Peruvian tax authority's actions constituted an expropriation of Tza's investment in TSG Peru S.A.C., a Peruvian company in the business of producing fish-based food products and export thereof to Asian markets.<sup>69</sup>

In addition to applying its "ordinary meaning" approach, the tribunal followed the guidance outlined in Article 31 of the Vienna Convention on the

Law of Treaties. It first referred to the Oxford Dictionary, which defines the word “involving” as meaning “to enfold, envelope, entangle, include.”<sup>70</sup> The tribunal then resorted to the Preamble of the BIT as supplementary means of interpretation. It recognized the purpose of including ICSID arbitration clauses is to attract and promote investments,<sup>71</sup> and considered the importance of granting the investor the benefits of submitting an expropriation-related dispute to the ICSID arbitration.<sup>72</sup> Finally, it confirmed that the right of submission to arbitration should not be excluded by the phrase “involving the amount of compensation for expropriation.”<sup>73</sup>

As noted by the SGCA, a fork-in-the-road provision requires a party to make an election on which remedy to pursue, and cannot subsequently opt for a different remedy.<sup>74</sup> The SGCA accepted *Sanum*’s contention that a narrow interpretation of Article 8(3) would require an investor to first approach to a court under Article 8(2) in order to determine whether an impermissible expropriation has occurred, thereby losing the option to arbitrate under Article 8(3).<sup>75</sup> Accordingly, the SGCA agreed with the tribunal that a narrow interpretation would contravene the principle of *effet futile* (effective interpretation).<sup>76</sup> The SGCA noted that a similar conclusion was reached in the ICSID decision in *Tza Yap Shum v. Peru*, where a similarly worded BIT between China and Peru was interpreted.<sup>77</sup> Singapore courts have consistently ruled in favor of a broad, effective interpretation of arbitration clauses, thereby demonstrating the pro-arbitration stance of the Singapore judiciary.<sup>78</sup>

#### • Limitation Period and MFN Treatment of Procedural Rights

There has been significant controversy over the extent to which the MFN provisions apply to substantive or procedural rights,<sup>79</sup> and whether the investor can invoke the MFN obligation to enjoy more favorable dispute resolution provisions in a host state’s BITs with other countries, which may include the consent to the ICSID arbitration for all disputes. Arbitration practice indicates that the broader the language used, the more likely is the tribunal to extend an MFN clause to cover procedural rights.<sup>80</sup> It has been confirmed in other cases that MFN treatment may be relied upon to broaden the tribunal’s jurisdiction<sup>81</sup> from disputes over the amount or payment of compensation, under the investor state-host state BIT, to all disputes including the existence of expropriation under a third-party BIT.<sup>82</sup> The

case law in this respect, however, is divergent.<sup>83</sup>

The tribunals in China's BIT-related cases have shown some consistency with not only reasons for rejection, but also interpretative techniques. In *Ansung Housing Co., Ltd. v. China*, Ansung sought to invoke the MFN clause in Article 3(3) of the China-R.O. Korea BIT to save its claim from being time-barred, as other Chinese BITs do not prescribe a three-year limit on initiating an arbitration claim against the host state.<sup>84</sup> Relying on a plain reading of the MFN clause,<sup>85</sup> the tribunal held that it did not extend to either a state's consent to arbitrate with investors, or the temporal limitation period for commencing investor-state arbitration in Article 9(7).<sup>86</sup> Further, the tribunal pointed out that the BIT offers specific MFN protection for investors' "access to courts of justice, administrative tribunals and authorities," making no reference to international dispute resolution such as arbitration under the BIT.<sup>87</sup> Accordingly, the tribunal dismissed the case as outside the applicable limitation period in Article 9(7).<sup>88</sup> This case appears to suggest that MFN provisions should not provide a way to escape limitation periods, though this may turn on the precise wording of the MFN provisions in question.

Chinese BITs have been characterized by relatively high bars to access to investment arbitration, reflecting an intentional policy of Chinese treaty drafters.<sup>89</sup> Many issues discussed in this article, such as the juristic way of applying fork-in-the-road provisions, limitation periods, and MFN clauses, indicate some conflicting features of Chinese BITs that have historically prevented foreign investors from accessing ISDS.<sup>90</sup> Narrow interpretations as adopted in *Heilongjiang*<sup>91</sup> could limit access to arbitration to cases in which the occurrence of expropriation has been declared or already determined.<sup>92</sup> Conversely, broad interpretations as adopted in *Tza Yap Shum*, and subsequently followed in *Sanum* and *BUCG*, suggest that the restrictive dispute resolution clauses found in China's earlier BITs do not limit arbitration to disputes on the amount of compensation for expropriation, thus giving Chinese or foreign investors more room to arbitrate expropriation claims.<sup>93</sup> A number of tribunals have shown a tendency to interpret treaties more expansively—an approach not favored by the Chinese government but technically in line with international norms for promoting and protecting cross-border investments.<sup>94</sup> Reliance on broader arbitration clauses and more expansive interpretation approaches are in the interests of Chinese investors, who need a

more vibrant ISDS regime to protect their rights while investing overseas.<sup>95</sup>

## **B. “Chinese Disequilibrium” in ISDS**

### **1. China Less Experienced in ISDS Cases**

There is a so-called “China disequilibrium” in international investment arbitration.<sup>96</sup> While China is second only to Germany in the number of investment treaties signed and has robust outbound investment flows, the number of investor-state arbitration cases involving China or Chinese investors is remarkably low.

China’s involvement in ISDS is highly asymmetric given the normative features of BITs, capital flow and ISDS.<sup>97</sup> Initially, the overall legal regime favored host states over investors, with diplomatic protection under weak norms of customary international law confronted by strong domestic law. Capital-exporting states, which until recently were the Western states and former colonial powers, needed more protection for their nationals than was provided by the domestic laws of capital-importing countries.<sup>98</sup> It was such initial asymmetry that the BIT framework generated at the request of capital-exporting countries sought to address.

### **2. Explanation of China’s Disequilibrium in Investment Treaties**

Two opposite schools of lawyers could potentially explain the “China disequilibrium.” One argues that the Chinese government is already offering sufficient investment protection to foreign investors,<sup>99</sup> resulting in few cases being brought against the Chinese government. However, this does not explain the very small number of investor-state arbitration cases in which Chinese investors are claimants, especially with China now the second-largest capital-exporting state and Chinese outbound investment often encountering legal, political, and economic difficulties in host states.

The other attributes the low utility rate of Chinese BITs to their restrictive terms, especially concerning the definitions of “investor,” “investment,” “dispute” and the treatment of fork-in-the-road provisions.<sup>100</sup> Early-generation Chinese BITs often narrowly defined “investor,” “investment,” and “dispute,” thereby heavily restricting the ability of foreign investors to initiate investor-state arbitration against the Chinese government for harming their interests. Preconditions such as “exhaustion of administrative review” and “cooling-off period” were generally

set to protect China's judicial sovereignty. Another pertinent consideration is foreign investors' concern about endangering future dealings with China, based on the long-held view that only disputes involving the amount of compensation for expropriation can be arbitrated under most Chinese BITs.<sup>101</sup> The Chinese government's previous non-commitment to international adjudication and its unwillingness to pay compensation also discourages investor-state claims against China. In some recent treaties, China has also required investors to partially exhaust domestic administrative remedies before initiating the arbitration.<sup>102</sup>

Further explanations include China's preference for settling disputes informally through diplomatic consultation<sup>103</sup> and foreign investors' possibility to gain more benefits through negotiation (rather than arbitration).<sup>104</sup> The Chinese administration is not enthusiastic about ISDS primarily because it impinges on China's sovereignty.<sup>105</sup> Until 1979, China's attitude toward foreign investment and its protection under international law was characterized by resentment and skepticism.<sup>106</sup> China deeply distrusted such institutions as the ICSID, which conflicted with its ideology and sovereignty.<sup>107</sup> Furthermore, the political culture of aversion to or weariness of litigation is deeply rooted in Chinese society and legal circle.<sup>108</sup> One reason is its emphasis on social reputation.<sup>109</sup> Under Confucianism, litigation and arbitration are viewed as disgraceful signals of the total breakdown of social harmony, whereas mediation affords people a socially acceptable method of resolving disputes. Accordingly, China strongly prefers political or diplomatic approaches.<sup>110</sup> Another reason is the governmental authority.<sup>111</sup> The government prefers not to involve in international disputes as it represents state sovereignty.

While the evaluation of the two arguments is beyond this article's scope, they prompt the question of how foreign investors can better protect themselves under China's restrictive BIT regime. Major capital-exporting countries argued for better substantive and procedural terms in new-generation BITs with the Chinese government, thereby upgrading the rights protection standards that were more favorable to the investors.<sup>112</sup> In his seminal article, Stephen Schill called for negotiations between Western European countries (in the interests of their outbound investment) and the Chinese government that were more rigorous in order to achieve more liberal and investor-oriented BITs.<sup>113</sup> Over the decade that followed, there were eight investor-state arbitration cases relating to Chinese BITs, in sharp contrast to the significant growth in the number of investor-state

arbitration cases worldwide. Surprisingly, most of these few cases concerned first-generation Chinese BITs with the abovementioned restrictive terms. This suggests that capital-exporting states such as Western European countries do not, in fact, need to tear down the Great Wall through treaty negotiations. A more effective alternative is to rely on the sophisticated methods of treaty interpretation adopted by investor-state arbitral tribunals.

## IV. POLITICAL ECONOMY AND CHINA'S FUTURE ENGAGEMENT

### A. Driving Force of ISDS

#### 1. The State's Interest in Foreign Investment

There are two common reasons for governments to sign BITs. First, to reduce the risk of investing abroad, the home state wants to secure credible commitments from the host state.<sup>114</sup> Second, host states competing to attract FDI<sup>115</sup> are willing to make credible commitments by raising the cost they would bear in case of default.<sup>116</sup> The most compelling clauses in BITs and the ISDS system contribute to a favorable investment climate by expanding economic and political cooperation between contracting parties; increasing the stability and predictability of the policy framework; and fostering good governance and the rule of law in both domestic and global contexts. Put simply, inter-state cooperation is not usually motivated by altruism or empathy for the plight of others, nor by pursuit of supposed international interests. Rather, states cooperate to seek wealth and security for their people, and the power to attain these ends.

The China-EU relations offer a useful illustration. Against the background of the US's wavering commitments to free trade and the global commons,<sup>117</sup> the EU leaders are simultaneously distracted by a full policy agenda, ranging from eurozone reform and debt crisis to refugees and Brexit.<sup>118</sup> With the development of its economy and domestic market, China wishes to increase its integration into the international order,<sup>119</sup> as well as its reciprocation of foreign investment.<sup>120</sup> BITs form a vital legal institution for FDI governance.<sup>121</sup> Although a BIT does not ensure increased investment flow,<sup>122</sup> investors certainly recognize the enhanced protection it provides.<sup>123</sup> A signed BIT with ISDS provisions not only helps

to build confidence among private investors,<sup>124</sup> but is also crucial to protect contracting parties' citizens investing abroad.<sup>125</sup> Given this mix of challenges and opportunities, the EU-China Comprehensive Agreement on Investment (CAI) will effectively promote sustainable, balanced, and inclusive growth of both economies, and elevate the economic relationship into a genuine strategic partnership.<sup>126</sup>

## 2. Market Liberalism for Economic Globalization

Economic development at both national and international levels may explain why the ISDS regime has been growing fast. Postwar global economic arrangements were built on the insight that to sustain a world economy hospitable to international investment, regulatory space must be reserved for domestic macroeconomic management. The GATT regime entailed a thin model of trade integration, only tackling direct border barriers and limited to trade in manufactured goods among advanced economies. It left considerable room for countries to design their own regulations and industrial policies-and indeed protect sensitive sectors such as agriculture or garments.<sup>127</sup> The liberal principle that free trade and investment promote peace is embedded in the trade and investment regime. Furthermore, the increasingly interconnected global value chains<sup>128</sup> promote the creation, structure, geography, distributive effects, and governance of different stages of production. These value production networks are driving structural shifts toward less trade-intensive but more service-oriented, less labor-intensive but more knowledge-driven, value production.<sup>129</sup> Firms are engaging dynamically with multiple overlapping and often conflicting local, national, regional, and transnational legal regimes, soft-law normative orders, and private ordering mechanisms.<sup>130</sup>

There has not been a clear consensus on whether it is economically profitable for countries to sign BITs.<sup>131</sup> Early econometric studies indicated a positive correlation between the signing of BITs and economic growth.<sup>132</sup> When BITs flourished in the 1980s and 1990s, outright expropriations of foreign investors-which had been common during the 1960s and 1970s-practically ceased.<sup>133</sup> Treaties including ISDS provisions indirectly have a positive impact on the FDI flows between signatory countries, especially for transitional and developing countries<sup>134</sup> in the long term.<sup>135</sup> This may result from addressing the lack of credibility that immediately follows regime change.<sup>136</sup> States that are reforming

and already have reasonably strong domestic institutions are especially likely to gain from ratifying a treaty.<sup>137</sup> Even signing a treaty has a slight positive impact on FDI,<sup>138</sup> though the investment amounts increased may be too small to significantly affect the total or bilateral flows of the host state.<sup>139</sup> This is because policies can affect other determinants of FDI flows, which usually takes time to materialize the change.<sup>140</sup> The level of domestic institutional quality is another key factor,<sup>141</sup> as BITs are complementary to good local legal systems.

Some studies report negative findings about the ISDS regime.<sup>142</sup> One concluded that including ISDS provisions in a trade agreement with the US would not particularly benefit the UK because “the US government assesses the UK as a very safe place to invest,” even without ISDS provisions.<sup>143</sup> If a host state is challenged in an international forum by a foreign investor, the positive effect on FDI flow may disappear or even turn negative.<sup>144</sup> Besides, the potential benefits only tend to accrue in sectors (those with higher sunk costs)<sup>145</sup> and are conditional on liberal rules on foreign investment admission.<sup>146</sup>

Although most BITs neither change the key economic determinants of FDI, nor substitute for sound domestic policies and legal frameworks,<sup>147</sup> they typically improve policy and institutional determinants and increase the amount of FDI that developing countries and transition economies are likely to receive.<sup>148</sup> This is especially helpful for countries with weak domestic investment frameworks and enforcement mechanisms.<sup>149</sup> BITs positively influence foreign investors’ perceptions to the enforceability of contractual arrangements and property rights.<sup>150</sup> Even investors not actually protected by a BIT may see it as signaling the host state’s willingness to engage in and formally commit to protecting FDI.<sup>151</sup>

### 3. Strengthening the Rules of the Game

Traditional arbitration possesses the advantages of expedition, expertise, and enforceability. It also reflects the fundamental need for freedom and autonomy with regard to dispute resolution by private decision. ISDS serves as a technical and institutional system replacing diplomatic protection or the host state’s domestic judicial or administrative system for dispute settlement.<sup>152</sup> As an international system to protect private capital, ISDS is rooted in contract law and commercial arbitration, which derives its legitimacy from the parties giving consent to arbitration and appointing the arbitrators.<sup>153</sup>

BITs provide a credible commitment to overcome the problem of time inconsistency.<sup>154</sup> The ISDS system, by providing a binding, consent-based, and external dispute settlement mechanism, ensures that host-state governments will honor their agreements. This not only increases the contract negotiation and enforcement efficiency, but also reduces the transaction costs associated with asymmetric information and bargaining power in signing and fulfilling the contract between the government and the investor. As the cost of investing is reduced, more investment will take place and the investment that does occur will be allocated more efficiently.<sup>155</sup> This indicates that BITs yield an efficient allocation of capital.<sup>156</sup>

## **B. Public Good for Global Governance**

As a kind of international public good covering more than one group of countries, the ISDS system provides globally available benefits extending to both current and future generations.<sup>157</sup> It is not only a mechanism to settle investment-related disputes between an investor and a state, but also a form of global governance, involving the exercise of power by arbitral tribunals in the global administrative space.<sup>158</sup> The non-excludable and non-rival characteristics of public goods<sup>159</sup> give rise to three major functions: risk reduction, capacity increase, and direct provision of utility.<sup>160</sup> In this regard, ISDS limits political power, protects foreign investment, and increases the predictability of economic and public policy.

However, the investment institution is a means to an end, not an end in itself. As the ICSID's own preamble emphasizes, private international investment is needed for international cooperation and economic development.<sup>161</sup> Investment is useful only insofar as it serves broader economic development and social goals (prosperity, stability, freedom, and happiness).<sup>162</sup> From a viewpoint of global efficiency, a regime that enables contracting between host governments and investors is more efficient than one in which potential hosts cannot effectively commit to any particular behavior or agreement.<sup>163</sup> The evolution of ISDS has paralleled fundamental shifts in global governance since the 1990s. It aims to assure justice and the rule of law as important aspects of international economic relations, the allocation of investment capital, and the liberalization of economic flows.<sup>164</sup> These objectives do not require just liberalizing trade and investment, but need to incorporate state-level policies and regulatory systems into a legal

structure meeting the basic requirements of legitimacy and justice in the allocation of economic resources.<sup>165</sup>

Yet, investment institutions must allow for diversity in national institutions and standards. There is no single formula for economic advancement. Citizens of different countries would have varying preferences over the regulation of new technologies, restrictiveness of environmental regulations, intrusiveness of government policies, extensiveness of social safety nets, and the broader relationship between efficiency and equity. When countries use the ISDS system to impose their institutional preferences on others, the system's legitimacy and efficacy are thereby eroded. By designing appropriate institutions of global economic governance, incorporating escape clauses and opt-outs, we can retain much of the benefit of economic globalization while allowing national democracies sufficient space to address domestic objectives.<sup>166</sup>

### **C. China's Future Engagement in the ISDS Regime**

Economic and political sensitivities are the two reasons why China favors ISDS. The purpose of BITs, especially ISDS provisions, is to stimulate foreign investments by reducing political risk.<sup>167</sup> ISDS gives states, businesses, and individuals the confidence to work together.<sup>168</sup> China wants to attract FDI by offering businesses a stable operating environment.<sup>169</sup> The need for a sound investment regime is facilitated by the rule-of-law strategy, the US-China political economy disputes, as well as participation in the global governance in an era of conflict and uncertainty.

#### **1. Promoting Inbound Foreign Investment and China's Outbound Investment**

As one of the world's most attractive investment destinations with the furtherance of its reform and opening-up strategy, China is required to optimize its foreign investment environment continuously, by adopting policies to promote trade and investment liberalization and facilitation at larger scopes; implementing the system of pre-establishment national treatment plus a negative list (Special Administrative Measures on Access to Foreign Investment); significantly easing market access; and building a transparent, efficient, and fair legal system.

With the rule of law at the top of its agenda,<sup>170</sup> China is attempting to create a predictable legal regime assuring certainty on what the law is, access to justice to

enforce the law, and a fair hearing before an independent judiciary.<sup>171</sup> The China International Economic and Trade Arbitration Commission has promulgated new investor-state arbitral rules intended to reduce what China considers its unfair treatment in arbitration cases.<sup>172</sup> China is firmly committed to protecting the lawful rights and interests of inbound foreign investors<sup>173</sup> by building an open and transparent foreign-related legal system; improving the business environment; and providing more certainty in legal institutions to all businesses that operate and invest in the country. China all also respects international business practices, observes the WTO rules, and treats equally all businesses registered within its borders.

Along the Belt and Road Initiative (BRI),<sup>174</sup> economic trade exchanges between involved countries have become increasingly closer. In the course of “Going Global,” Chinese enterprises are likely to encounter political, economic, legal, and financial risks in their overseas operations. Correspondingly, the need for efficient settlement of investment disputes is becoming ever more pressing. In this context, investment arbitration-as an important method of ISDS - has also entered a new development phase in China.

## 2. Adhering to Multilateralism in Global Governance

While global economy is changing, the Washington Consensus (including free trade and open markets) has been severely challenged. There are three major shifts in global economic thinking. First is the tendency of nationalism in the market economy.<sup>175</sup> Second is the regression from liberalism to protectionism,<sup>176</sup> characterized by the overuse or even abuse of national security to restrict foreign investment, resulting in a decline in FDI. Third is the transition from fictitious to real economy.<sup>177</sup> Governments have been adopting various policies to create a better environment for developing manufacturing industries, in some cases through targeted industrial policies to support high-end manufacturing industries of strategic importance.

Against the backdrop of such global challenges, especially the turbulence afflicting economic globalization, the China-US relations have undergone profound changes and corresponding policy adjustments.<sup>178</sup> To exert pressure on China to open its markets, a “poison pill” provision was inserted in the recently completed United States-Mexico-Canada Agreement (USMCA).<sup>179</sup> Under this

provision, if any of the three members enters a trade deal with a non-market country, the other two are free to quit after six months and form their own bilateral trade deal.<sup>180</sup> This provision in the USMCA effectively gives Washington a veto over Canada's and Mexico's other free-trade partners.<sup>181</sup> Such infringement of sovereignty does harm each other in principle and in tactics, as it factually restricts the countries' autonomy in signing agreements and trading with other countries (particularly China).<sup>182</sup> Trade agreements should only cover trade between signatories without limiting their rights to negotiate with other parties.<sup>183</sup> By accepting the "poison pill" clause in the USMCA, Canada and Mexico have willingly limited their ability to diversify their export markets.<sup>184</sup>

Another driver of China's evolving attitude toward international adjudication is its sense of identity with fundamental values in international relations.<sup>185</sup> The need for governance by rule of law applies equally to China's relations with other states as it does within the country. Over time, China has developed trust in the international system and shifted toward acceptance of ISDS, perceiving it as an appropriate mechanism that has neither imposed a significant compensation burden, nor impeded sovereign acts in the public interest. As ISDS is an integral part of the international economic infrastructure, China wants to participate in its evolution and development.<sup>186</sup> The US administration's leadership and competition agenda against China also push China to seek alternative cooperation with other states.<sup>187</sup>

The ISDS regime will be an essential part of wider range of international economic institutions together with the WTO dispute settlement system and commercial arbitration. Premised on amity, sincerity, mutual benefit, and inclusiveness, China has proposed upgrading the China-ASEAN Free Trade Agreement to complement the establishment of the Asian Infrastructure Investment Bank and the construction of the BRI through Eurasia as major initiatives promoting strategic cooperation with neighboring countries. Together, these constitute the first moves in China's expansion of opening up to the outside world.

### 3. Participating in Global ISDS Reform

As one of the strong supporters for globalization, China is actively participating in global ISDS reform, despite the remarkably low number of investor-state arbitration cases involving Chinese investors or the government. In the thirty-eighth

session of UNCITRAL on July 18, 2019, the Chinese government submitted its recommendations on possible reform of ISDS.<sup>188</sup> This submission pointed out that the existing ISDS mechanism has many issues that deserve the attention of all countries involved: these problems include the lack of an appropriate error-correcting mechanism, the instability and unpredictability of arbitral awards, the questionable professionalism and independence of arbitrators, the influence of third-party funding, the lengthy time frames, and excessive costs.<sup>189</sup>

Several proposed solutions for reform were inspired by the EU's MIC design. For example, China's submission suggests setting up a permanent appellate mechanism to improve error correction; strengthen the expectation that parties will attempt to settle disputes; establish limitations to judges' conduct; and foster further standardization and clarification of procedures. These improvements would reduce the abuse of rights by parties to disputes—one key reason why the EU's MIC design included a permanent appeal tribunal.<sup>190</sup> The submission also suggests introducing stricter limitations to the qualification of arbitrators, arbitral procedures, waiting periods to launching disputes, and third-party funding. In this regard, the reform protects not only the legitimate regulatory power of the host country, but also the rights and interests of investors, as well as enhancing the confidence of arbitrating parties in the dispute settlement mechanism between investors and the state.<sup>191</sup>

On December 30, 2020, after 35 rounds of negotiations, China and the EU reached a consensus on the CAI, part of which was published on January 22, 2021.<sup>192</sup> Just like the Regional Comprehensive Economic Partnership (RCEP) that China signed on November 15, 2020, the CAI leaves the contents of ISDS reform to be further negotiated. Specifically, the Parties agree to continue, on the basis of the progress already made, their negotiations “with a view to negotiating an agreement on investment protection and investment dispute settlement ... [and] the Parties shall endeavor to complete such negotiations within 2 years of the signature of the present agreement.”<sup>193</sup>

In summary, both the CAI and the RCEP have created sufficient space for future amendments, as China is expected to push forward the ISDS reform with similar intention and approach to these agreements with the aim of strengthening international cooperation.

#### **D. Expectations of China's ISDS Reform**

A significant change of the global economy in recent years is China's transformation from a traditional capital-importing state into one of the largest capital-exporting states. It raises new issues over how to protect the interests of Chinese outbound investments. Neither the proposals China submitted to UNCITRAL nor the newly signed investment agreements with the EU (CAI) and South-East Asian Nations (RCEP) contain exact details on how to regulate and solve investment disputes. Nevertheless, the principles and arrangements agreed in relevant provisions (such as Article 19.11 of RCEP) indicate China's preference for international institutions such as the WTO and PCA. To better regulate foreign inbound investments and protect outbound investments, China needs to accommodate the following interests of all parties.

First, legitimate rights between the host state and foreign investors should be well balanced. One main criticism of ISDS is its interference with a state's legitimate regulatory power. In some investor-state disputes, a ruling favoring the investor may require the state to postpone or even cancel legislation on domestic issues. In pursuing the benefits of multilateralism, China should pay attention to preserving domestic public interests as well as the legal rights of foreign investors. For example, in the future negotiations of ISDS reform, China could add clauses and terms to affirm its right to regulate within its territories so as to achieve legitimate policy objectives or exclude the application of investment court system or MIC for the issues relevant to vital public interests, such as environmental protection, national security, and financial markets.

Second, the dispute settlement system should be more transparent and impartial. As shown by its submission to UNCITRAL, the Chinese government is focusing on reforming the structure of the arbitration system. China supports establishing a permanent appellate mechanism, allowing the parties to appoint arbitrators, improving the qualifications of arbitrators, providing alternative dispute resolution measures (include pre-arbitration procedures), and requiring greater transparency on third-party funding.<sup>194</sup> All these suggestions indicate China's strong interest in transforming the arbitration system into a more standardized and formal structure.

Third, considering that China is trapped in trade disputes with many Western states, the Chinese government should promote the ISDS reform that helps

Chinese investors and corporations resist political intervention and supervision. The US-China trade war and recent political disputes with Australia have proved the need for a more neutral tribunal and appeal mechanism, especially to protect the interests of investors from China. It may be difficult for China to persuade other countries to accept terms of the agreement that require absolute depoliticization of their treatment of foreign investment. It is also questionable whether the ISDS reform to prevent political intervention would be effective, as most states are reluctant to give up their legitimate power.

## V. CONCLUSION

As the world economy is getting more open today, the most important challenge it faces is a lack of legitimacy.<sup>195</sup> The investment community is demanding the certainty and predictability provided by relevant rules, a level playing field, and a reliable dispute resolution system that is effective, just, and timely. This is why wider and deeper reform of institutions like ISDS matters. The ISDS system focuses on improving the investment environment of countries and strengthening the contractual relationship between governments and foreign investors.

The design of the ISDS mechanism is shaped by a fundamental trade-off. On the one hand, the relationships between capital-importing and capital-exporting countries and these countries' preference for heterogeneity "push governance down," with larger state regulatory space and variance of protection standards.<sup>196</sup> By bringing claims under the ISDS arbitration mechanism, foreign investors have found a way to interfere with the legitimate regulatory power of host states by challenging the enforcement of laws and regulations designed and approved under legitimate domestic procedures.<sup>197</sup> A growing number of states have complained that this mechanism is eroding their sovereignty.<sup>198</sup>

On the other, the scale and scope of the benefits of market integration "push governance up," with more coherence and consistency in advocating investor's rights protection standards and arbitral decisions.<sup>199</sup> Foreign investment have been seriously decreasing, especially since the emergence of the pandemic.<sup>200</sup> It can be hard for states to grow without foreign investment given their depressing domestic economies.<sup>201</sup> States are at different stages of development, having different

economic, political, social, cultural, and legal systems.<sup>202</sup> Therefore, some level of investment friction is natural.<sup>203</sup> A pluralist world economy is necessary where nation-states retain sufficient autonomy to fashion their own social contracts and develop their own economic strategies.<sup>204</sup> These flexible national policies may be achievable through the formation of customary international law, whose requirements are evidently fulfilled.<sup>205</sup>

Faced with contestation over the ISDS reform between the US and the EU, China should adhere to the multilateralism and promote incremental reform of current ISDS through modifying its international investment treaties with less-developed countries. In a world of increasing uncertainty, instability, and insecurity, all countries shall keep its original aspiration, follow the contemporary trend, assume its responsibility for justice, and pursue the greater good. China will also advocate balanced rules on investment dispute settlement. The key to reforming the international investment is to promote the rule of law, which comprises three critical aspects: fairness, independence, and consistency. Achieving this will require long-term efforts by the international community including China.

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