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How to limit treaty-shopping[*]

by
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Under the vast majority of international investment agreements (IIAs), mere incorporation, including through "letter-box" arrangements, is a sufficient criterion for determining the nationality of companies. Investors can, therefore, incorporate in countries that have IIAs favorable to them and invest from there in other countries (including their home countries—"round-tripping") to obtain treaty protection.[1] Arbitrators have tolerated—and scholars have mostly accepted—such "treaty shopping".[2] It has been justified by the legal certainty provided by the incorporation test and a strict constructionist interpretation of treaty definitions for the purpose of establishing arbitral jurisdiction. Furthermore, tribunals seem to think that the primary function of investment protection is to promote capital inflows, irrespective of their foreign source or their origin from a contracting state of the relevant IIA (round-tripping).

While incorporation through regional headquarters may be justified by organizational and strategic considerations, using "letter-box" (or "shell") companies and round-tripping[3] may be criticized as undesirable, for the following reasons:

- legal formalities should not prevail over the economic reality underlying the corporate structure of investors;
- the aggregate balancing between the protections and obligations embodied in applicable IIAs should not be altered;
- the fabrication of treaty-based jurisdiction not consented to (and not reasonably envisaged) by the contracting parties should not be upheld by tribunals;
- opportunistic behavior, such as free riding or moral hazard where the costs of establishment are minimal, should be prevented;
- the truly foreign character of investments should be preserved (round-tripping);
- the unreasonable discrepancy with the treatment of other domestic investors should not be permitted (round-tripping);
- the ensuing possibility of legal arbitrage among the applicable IIAs may engender even more unpredictability concerning the basis of consent to arbitration;

- the untenable disparity with the treatment of natural persons should not be accepted. Under the vast majority of IIAs, the nationality of individuals is determined upon reference to the law of the country whose citizenship is claimed, and the requirements are usually stricter than the formal test of incorporation.

Broadly construed, treaty shopping may also refer to the import of more favorable dispute-settlement clauses via most-favored-nation (MFN) treatment. This is controversial when pertaining to the jurisdiction of arbitral tribunals (e.g., as to the availability of arbitral institutions, such as ICSID or UNCITRAL, which may not be expressly named in dispute-settlement clauses) or to the admissibility of claims (e.g., as to waivers of mandatory pre-arbitration procedural requirements pursuant to applicable IIAs). While the distinction between substantive and dispute-settlement provisions for the purposes of MFN treatment is not posited under customary international law, tribunals remain divided, which is one more source of unpredictability regarding issues of jurisdiction and/or admissibility.

Such interpretative issues should preferably be solved by governments in the negotiation or revision of their IIAs.

Governments intending to limit treaty shopping can pursue various avenues when drafting agreements. They should:

- demand "substantial presence", i.e., substantive business activities in the home country; for example, the term "investor" could refer to "an enterprise of a Party" meaning "an enterprise that is constituted or organised under the laws of that Party and has substantial business activities in the territory of that Party";[4]
- require that control is effective, based on, for instance, managerial elements;
- stipulate mandatory denial-of-benefits clauses, empowering host countries to withdraw treaty advantages if investors do not conduct substantial economic activity in the home country or are owned/controlled by legal persons of third countries or the host country (round-tripping); and
- expressly carve-out dispute-settlement issues from MFN clauses to prevent their extension to questions of jurisdiction and admissibility.[5]

These are investment treaty providions available to governments willing to put an end (or at least to contain) treaty shopping. Doing so would also foster the legitimacy of investor-state dispute settlement based on IIAs through the advancement of legal security and predictability.

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[1] Julian Chaisse, "The treaty shopping practice: Corporate structuring and restructuring to gain access to investment treaties and arbitration," *Hastings Business Law Journal*, vol. 11 (2015), p. 228: "treaty shopping [is] the process of routing an investment so as to gain access to an IIA where one did not previously exist or to gain access to more favorable IIA protection."

[2] With few exceptions, e.g., Prosper Weil in *Tokios Tokelės v. Ukraine*, based on a teleological interpretation of the ICSID Convention.
[3] "Round-tripping" is one of the most objectionable forms of treaty shopping as it conflicts with the principle of diversity of nationality for the access to international jurisdiction.
[4] Comprehensive Economic and Trade Agreement (CETA), Article 8.1.
[5] See, the 2018 Netherlands Model BIT (the Netherlands have traditionally been a home country for "letter-box" companies), the EU-Vietnam Investment Protection Agreement and Chapter 8 of the CETA.

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