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THOUGHT LEADERSHIP BRIEF

KEY POINTS

- As part of a long-term strategy, China needs to improve investment treaty network to enhance protections for foreign investors.
- In the short and medium-term investors need to carefully consider investment insurance products to protect their foreign investments.
- BRI investors need to be aware of existing venues for the solution of BRI disputes such as the HKIAC, CIETAC, and the newly established CICC.
- Mediation is a viable and increasingly effective way to solve BRI disputes.

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Protecting Foreign Direct Investment in the Belt and Road Countries

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Issue

The Belt and Road Initiative (BRI) is increasing foreign direct investment (FDI) flows from China to BRI countries. Many BRI investments, especially in large infrastructure projects, face substantial risk, because they feature large up-front capital expenditures that require long time horizons in order to generate returns. BRI recipient countries are very heterogeneous, with different degrees of economic development and openness, and regulated by different legal regimes. Some suffer from high levels of corruption and poor governance, which undermine the trade, investment, and general business environment. The complexity of some projects and their geographic scope across more than one jurisdiction adds to the legal risk. In these circumstances, investments are affected not only by economic and financial risks but also face severe political and regulatory risks.

The BRI is not based on any enforceable comprehensive international legal instrument, such as a comprehensive investment agreement, that regulates and secures investor rights. Rather, the BRI relies on a network of memoranda of understanding and declarations that are neither binding nor enforceable. Chinese investors must rely on a regime of investment agreements that are often obsolete and offer limited protections. Given this reality, Chinese companies considering investments in Belt and Road countries need to be aware

Reference

Bryan Mercurio and Dini Sejko, Holes in the Silk: Investor Protection under China's Belt and Road Initiative, Global Trade and Customs Journal 2019, Volume 14, Issue 5.

of the extent of legal protections available in different Belt and Road countries, and consider alternative strategies to deal with these risks. The Chinese government should prioritize improving these protections as soon as possible in order to better protect the interests of Chinese investors which can also spur more investment flows.

Assessment

We conducted a systematic assessment of legal disputes involving Chinese investors in Belt and Road countries to assess key issues that influence the extent of legal protections to Chinese investors (Mercurio & Sejko 2019). The regime of Chinese international investment agreements (IIAs) can be divided into three main groups, depending on when they were negotiated, and the type of investment protection provided. They reflect the evolution of political and economic considerations as China has transformed and become a main source of FDI. The first generation of IIAs were negotiated between 1982 and 1989, before China joined the International Centre for Settlement of Investment Disputes Convention (ICSID) and are characterized by weak substantive protections and limited access to investment arbitration. The second generation of agreements negotiated between 1990 and 1998 provide weak substantive protections but include greater – but still limited – access to arbitration. The third generation of investment agreements were negotiated since 1998 and include among others the agreements signed with the ASEAN member states, and Uzbekistan. These treaties provide substantial protection of investments, including national treatment and most-favoured nation status as well as access to ICSID arbitration tribunals.

The great majority of investment treaties in force between China and the BRI countries belong to the first and second-generation and are characterized by terms that are encouraged but not required. More importantly they contain investor state dispute settlement (ISDS) clauses with a limited amount of compensation payable to investors in case of expropriation. Thus, early Chinese treaties greatly reduce important protections for foreign investors in clauses related to national treatment, most-favoured nation status, fair and equitable treatment, and full protection and security. Another problem with China's first- and second-generation BITs is enforcement. They generally provide for the establishment of *ad hoc* tribunals (with only limited use of ICSID arbitration tribunals) that can only decide cases dealing with the amount of compensation in case of expropriation. In addition, non-ICSID awards require much more complicated enforcement procedures.

Table 1: Old cases and lessons for current investors

Year of initiation	Case Name	Home State of the Investor	Outcome	Topical Issue
2017	Sanum Investment v Laos	Macau SAR; China	Pending	Nationality of the investor
2014	Bejing Urban Construction Group (BUCG) v Yemen	China	Settled	State-owned/state-controlled nature of Chinese investors
2012	Ping An v Belgium	China	In Favour of the State	Relationship between new and old BITs
2010	Beijing Shougang and others v Mongolia	China	In favour of the State	State-owned/state-controlled nature of Chinese investors
2007	Tza Yap Shum v. Peru	Hong Kong SAR; China	In favour of Investor	Nationality of the investor

Source: Elaboration on UNCTAD Investment Policy Hub

Chinese state-owned investors may face problems when treaties define the investor without clarifying if state-owned investors should be treated as private investors. Usually, qualified investors are "economic entities established in accordance with the laws of the People's Republic of China and having their seat in its territory" (China-Greece BIT 1992 art. 3). It is possible that a SOE might be operating unprofitably or on a cost recovery basis if the investment does not pursue solely economic objectives. In recent treaties, China has changed the language to provide greater clarity and use the term investor to refer to companies, firms, associations, partnerships and other incorporated organizations without distinguishing whether they are for profit or whether they are state-owned or private (for ex. China-Uzbekistan BIT 2011 art. 1).

The situation is more critical in a limited number of countries with which China does not have any investment agreement. Chinese investors do not have any treaty protection in countries including Afghanistan, Bhutan, Iraq, Montenegro, Nepal, and Palestine, all of which receive Chinese outbound FDI. Chinese investors are already facing legal difficulties in some of these countries and should exercise extra caution when investing in such markets.

An analysis of the investment cases involving Chinese investors in the recent past, summarized in Table 1, provide instructive lessons for current and future Chinese investors. The Ping An case illustrates the differences between the old and new investment agreements. Chinese investors brought a claim against Belgium under the old agreement as well as under a new agreement negotiated in 2005. The investors claimed that an intervention from the Belgium government to save the financial services company known as Fortis Group resulted in a breach of the direct expropriation clause and the fair and equitable treatment clause. Ping An relied on the older bilateral investment treaty (BIT) for the substance of the claim, and on the modern BIT for the tribunal's jurisdiction, so that it could benefit from the latter's improved dispute settlement clause which provides jurisdiction not only for the amount of compensation. The tribunal disagreed with the position of Ping An and explained that the new BIT did not cover the dispute between the claimant and Belgium since the dispute matured before the new BIT entered into force.

Beijing Urban Construction Group (BUCG) is a Chinese provincial state-owned enterprise (SOE) that won an international bit to build a section of the Sana'a International Airport in Yemen, which is a BRI country, but the facts of the case predate the BRI. Yemeni military forces prevented BUCG workers from accessing the work site and arrested some of them which delayed construction. Subsequently, the Yemeni aviation authorities announced their intention to terminate the construction contract. When BUCG lodged an ICSID claim, Yemen contended that because BUCG did not have the right to bring an ICSID claim because of the state-ownership and control. The tribunal determined that BUCG, is part of the large Chinese state-controlled economy however, and more importantly recognised that the control of the Chinese government was to remote from the facts of the case to qualify the state as the ultimate decision-maker for the key management, operational, and strategic decisions related to the project. The tribunal clarified that BUCG was not a governmental agency and was not exercising governmental functions in Yemen. Consequently, the arbitral tribunal granted jurisdiction to the state-owned investor.

Similarly, in the Beijing Shougang case, the tribunal accepted that the group of SOEs that invested in Mongolia are economic entities and satisfy the definition of investor required by the China-Mongolia BIT (1991). This provides a positive precedent for the protection of the investments of SOEs in BRI countries. However, investor-state arbitration is not based on a formal system of precedents and so it is not possible to deduce from the awards that in the future Chinese SOEs participating in BRI infrastructure projects will be granted claimant status in front of ICSID tribunals.

Other important issues related to Chinese IIAs are the limited scope of the application of the most-favoured nation clause to widen the scope of dispute settlement, and the application of Chinese investment agreements to investors from Hong Kong SAR or Macao SAR, which were key issues in the Laos and Peru cases in Table 1, more details of which are discussed in Mercurio & Sejko (2019).

Recommendations

There is a general need for China to improve the trade and investment framework with BRI countries, which is recognised by the 2015 Chinese government circular on Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road. President Xi also has advocated for the negotiation of new international agreements that support trade, investment, and enhanced integration along the Belt & Road area.

The negotiation of new treaties is part of a long-term strategy. Existing negotiation platforms such as the Regional Comprehensive Economic Partnership, the China–Gulf Cooperation Council Free Trade Agreement, and the EU–China investment agreement are expected to address some of the most significant issues however the same investment strategy and template to negotiate with all BRI countries will not be effective because of different investment environments.

In the short and medium-term investors need to rely on other options such as insurance for the protection of investments when existing treaties provide limited protections. State-owned and private investors could increase use of investment insurance, for example those offered by the Multilateral Investment Guarantee Agency. Chinese entities, such as Sinosure, provide tailored insurance products for BRI investments, but purchasing such insurance increases investment cost. Such costs can easily be covered by large state-owned investors and Chinese corporations which have the know-how and resources to rely on expensive consultancy and legal services. On the other hand, small and medium size enterprises may not even be aware of the gaps in legal protection, and the risks they are being exposed to when making investments in BRI countries.

Chinese investors should be aware of the increasing number of dispute settlement mechanisms that are becoming available to them. In June 2018, the Chinese Supreme People's Court established the China International Commercial Court (CICC) to serve as a comprehensive BRI dispute resolution platform – including mediation, arbitration and litigation – for international commercial cases. **The Hong Kong International Arbitration Centre (HKIAC) or the China International Economic and Trade Arbitration Commission (CIETAC) might be more attractive to non-Chinese parties** that might be concerned about jurisdictional, linguistic, and enforcement issues with respect to CICC.

Chinese and non-Chinese investors should also consider mediation in order to solve investment and commercial disputes. Since August 2019, parties can also rely on the United Nations Convention on International Settlement Agreements Resulting from Mediation, for the enforcement of the settlement agreements.

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