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Bilateral Investment Treaties

– a shield or a sword?

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Why is the South African government canceling bilateral investment treaties (BITs) with its most important foreign investor countries? It was recently announced that South Africa had terminated Promotion and Protection of Investment treaty with Switzerland. South Africa has also recently terminated its BITs with the Netherlands, Spain, Luxembourg and Belgium and Germany, and it appears that other cancellations are in the pipeline. In the current economic climate, with questions being asked by foreign investors about labour relations, the implementation of the new order mining rights regime and governmental policy drift generally in South Africa, is this the time to be canceling treaties which guarantee foreign investors in South Africa's economy certain protections and assurances?

The Government's reply is that it is not doing away with foreign investor protections but is rather making changes to the way in which those protections are ensured, whilst maintaining its right to implement policies to address the country's social and economic requirements and to redress the injustices of past through its affirmative action policies. The Department of Trade and Industry (DTI) carried out a review of South Africa's BITs and concluded in 2010 that South Africa's BITs extend too far into the policy sphere, as the first generation of BITs, which the Government entered into post-1994, were allegedly skewed towards investors and that aspects of its BITs were incompatible with the Constitution and other South African laws. It further concluded that BITs allowed for legal challenges to regulatory changes, which the Government considered to be in the public interest. The DTI therefore recommended that South Africa restructure its policy framework to ensure that South Africa's broader social and economic priorities are not undermined. Some insight into the Government's line of thinking was revealed by Dr Rob Davies, the South African Minister of Trade and Industry, at a United Nations

Conference on Trade and Development Investment Policy Framework for Sustainable Development in Geneva in September 2012 when he said:

"The recommendations emanating from the Review were largely endorsed by the South African Cabinet in April 2010. Cabinet understood that the relationship between BITs and FDI was ambiguous at best, and that BITs pose risks and limitations on the ability of the Government to pursue its Constitutional-based transformation agenda. Cabinet concluded that South Africa should refrain from entering into BITs in future, except in cases of compelling economic and political circumstances. It instructed that all "first generation" BITs which South Africa signed shortly after the democratic transition in 1994, many of which have now reached their termination date, should be reviewed with a view to termination, and possible renegotiation on the basis of a new Model BIT to be developed."

In subsequent public statements on this issue (including the DTI's "Update on the Review of South Africa's Bilateral Investment Treaties") the Government referred to the introduction of legislation to replace the protections afforded by BITs. On 1 November 2013, the Government published the draft Promotion and Protection of Investment Bill for public comment. On the face of it, the Bill includes the usual features of bilateral investment treaties whilst introducing measures which address the concerns identified in the DTI's review, thereby attempting to redress the balance between the needs of foreign investors and the Government's right to implement policy. In essence, the Government appears to be attempting to recharacterise investor protections as a shield and not sword.

South Africa's Foreign Investment Protection History

Whilst the WTO/GATT has successfully established a multilateral process for reaching agreement between countries as to matters of trade, cross border investment has continued to be regulated bilaterally between sovereign states. During the apartheid era South Africa entered into very few BITs. After 1994 the South African government entered into a flurry of bilateral investment treaties with developed countries, principally European countries who were equally keen to support its transition back into the community of nations, with a view to encouraging foreign investment in the new South Africa. South Africa was not alone in increasing its BITs with other countries. During the 1990s 1,472 BITs were entered into between nations. During the immediate post-apartheid period (1994-1998) South Africa entered into 15 BITs, mostly with European countries. In total it has entered into 47 BITs, although not all of them are in effect. In respect of the top 10 foreign investor countries in South Africa, seven BITs have been entered into (see table).

| COUNTRY | DATE OF SIGNATURE | DATE OF ENTRY INTO FORCE | DATE OF NOTICE OF TERMINATION |
|---------------------------|-------------------|--------------------------|-------------------------------|
| 1. United Kingdom | 20/09/1994 | 27/05/1998 | - |
| 2. The Netherlands | 09/05/1995 | 01/05/1999 | 01/11/2013 |
| 3. USA | - | - | - |
| 4. Germany | 11/09/1995 | 10/04/1998 | 23/10/2013 |
| 5. China | 30/12/1997 | 01/04/1998 | Discussions under way |
| 6. Switzerland | 27/07/1995 | 29/11/1997 | 30/10/2013 |
| 7. Japan | - | - | - |
| 8. Malaysia | - | - | - |
| 9. Luxembourg and Belgium | 14/08/1998 | 14/03/2003 | 07/09/2013 |
| 10. France | 11/10/1995 | 22/06/1997 | - |

South Africa's BITs, in common with many other countries, seek to give foreign investors certain well established protections and assurances in order to promote foreign investment in the economy including assurances as to expropriation (and compensation where it does occur), security, repatriation of capital and income from investments equality of treatment with domestic investors and international arbitration of disputes. The earlier treaties were based on an OECD template for BITs and it seems that the current administration is of the view that, in the desire to attract foreign investment, insufficient heed was paid to the less obvious, and less attractive, consequences of those treaties.

Given the generally confidential nature of arbitration proceedings, and even more so correspondence threatening to invoke treaty provisions, it is not altogether clear whether the DTI's concerns are real or hypothetical. It is known that since 2000 there has been a marked increase in arbitrations under BITs worldwide - clearly the risk of claims arising has increased. The DTI has publicly acknowledged two disputes or claims (however, there may be more). In the first dispute, which arose in 2004, a Swiss investor who had acquired a private game reserve which was subject to poaching, vandalism and theft alleged that the Government had failed in its treaty obligations to provide "protection and security". The second dispute, which arose in 2006, under the Italian treaty, dealt with alleged expropriation of mineral rights, a failure to apply "fair and equitable treatment" (see below) and specifically objected to the application of black economic empowerment (BEE) rules.

International Treaties v Domestic Legislation

The South African government's decision to review its approach to BITs is not completely unusual - other countries, including the United States and Canada, have revised their BIT templates to narrow investor protections. However, apart from the changes which have been introduced by the Bill, the use of domestic legislation itself rather than an international treaty is a departure from South Africa's previous approach to foreign investor protection. The important distinction is that a treaty is a form of agreement between nation states and, like most agreements, cannot be amended unilaterally by one party to it. On the other hand, domestic legislation is subject to amendment by one of the protagonists, namely the government (with the approval of the legislature). From a foreign investor's perspective, the mere adoption of domestic legislation to replace bilateral treaties in itself diminishes the degree of protection afforded by it. The Bill itself also introduces some substantive, sometimes subtle, changes to investor protection principles under BITs whilst, on the face of it, including the usual provisions. Some of these are examined below.

Expropriation and compensation

A typical concern of foreign investors is that their assets will be expropriated by appropriation, confiscation or nationalisation. BITs typically include protection against expropriation, except for a public purpose on a non-discriminatory basis (eg compulsory purchase for a road widening project), and provide for compensation in the event of expropriation and South Africa's BITs are no exception. Section 8 of the Bill is headed "*Principles relating to expropriation of investments*" and provides that "*An investment shall not be expropriated except in accordance with the Constitution and in terms of other laws of general application, for public purposes or in the public interest.*" Essentially, this provides a foreign investor with the same rights as a domestic investor in South Africa. In terms of

section 25 of the Constitution, “No one may be deprived of property except in terms of law of general application, and no law may permit arbitrary deprivation of property” and that “property may be expropriated only in terms of law of general application...for a public purpose or in the public interest”.

Although, on the face of it, this does not appear to be a material departure from the traditional BIT approach, it seems likely that the Government’s purpose in reformulating the protection is to protect itself against claims by foreign investors that regulation of the rights of persons over their property (e.g. black economic empowerment legislation and in particular the Minerals and Petroleum Resources Development Act (MPRDA)) may amount to indirect expropriation of property. The Italian claim referred to above sought to rely on just this line of argument.

Furthermore the measure of compensation provided for under the Constitution differs from, and affords less protection, than that provided under the BITs. South Africa’s BITs use language such as genuine value, actual value, real value and market value. These are all generally understood to import a concept akin to market value. The Constitution however provides for compensation to be “*just and equitable, reflecting an equitable balance between the public interest and the interests of those affected, having regard to all relevant circumstances*”. The public interest is expressly stated to include “*the nation’s commitment to land reform, and to reforms to bring about equitable access to all South Africa’s natural resources*”. On balance this methodology is more likely to provide compensation at less than market value. Whilst foreign investors might not have the greater protection afforded by treaty, the Government would no doubt argue that foreign investors should not enjoy greater protection than domestic investors.

Repatriation of investments and returns

Investors want assurance that, having invested in a foreign country, they will be entitled to repatriate the capital invested and the income arising from that investment. The latter is typically referred to in BITs as “returns” and defined to include profits, interest, dividends, capital gains, fees and royalties. BITs typically permit a foreign investor to repatriate its investment and returns. The Bill does not do so. In fact it does not define or refer to repatriation in this context at all. Section 10 simply provides that: “*a foreign investor may, in respect of any investment, transfer funds, subject to taxation and other applicable legislation.*” It is not known whether the Government has deliberately excluded reference to returns or whether it intends “funds” to be synonymous with “returns”. In any event, the section does not expressly provide a right of repatriation of investments and returns. Whilst it does not expressly prohibit transfers of funds outside South Africa, the inclusion of the words “other applicable legislation” imports exchange control requirements. Whilst these for the time being, generally allow for the repatriation of investments and returns, this state of affairs is not assured as the Government may (unilaterally) change the regulations at any time in the future.

National treatment

In common with other BITs, South Africa’s BITs include a guarantee that foreign investors will be treated as favourably as domestic investors – the so called “national treatment” protection. Its purpose is to protect foreign investors against law and regulation or government policy which may treat domestic investors more favourably than them. Again, the Government’s affirmative action policies, designed to redress the inequalities of the apartheid era in favour of previously disadvantaged South Africans, risk being incompatible with national treatment principles.

Section 6 of the Bill imports the concept of national treatment but qualifies it by reference to applicable legislation and “like circumstances”. It seems that the Government’s intention here is to subject national treatment to the supremacy of domestic legislation and, through the “like circumstances” test, to prevent foreign investors from enjoying greater rights than, or avoiding law and regulations applicable to, domestic investors.

Fair and equitable treatment

Fair and equitable treatment is a common principle of BITs and, as an example, can be found in Article 3 of the BITs entered into with the UK and Netherlands. It is accompanied by an additional obligation on the host government not to impair by “unreasonable or discriminatory measures”, amongst other things, the use, management or enjoyment of the investment. This provision has formed the basis of many claims made in terms of BITs worldwide and appears to have also been problematic from the South African government’s perspective. In the Italian case, the claimants reportedly asserted that the MPRDA did not afford them “just and fair” treatment as it preferred historically disadvantaged South Africans.

The Bill includes a section under the heading “Protection of investments”. This heading is typically used in BITs for the article containing fair and equitable treatment provisions. Notwithstanding its heading, section 5 does not include any fair and equitable treatment protections. In fact it does not afford foreign investors any protections at all but rather limits their rights. It expressly provides that it shall not be interpreted as giving foreign investors any right of establishment in South Africa and that all investments are subject to compliance with domestic laws (presumably the Government does not mean to make investments conditional upon compliance but is merely asserting that investments are subject to domestic laws).

Full protection and security

The fair and equitable treatment principle is usually accompanied by a “full protection and security” obligation (see Article 3 of the UK and Netherlands BITs). This obligation clearly applies to state forces and institutions but, on some interpretations, also imports an obligation on host nations to protect investors against actions by private citizens. Indeed, it may imply that foreign investors are entitled to a greater

degree of security than domestic investors. This imposes a fairly onerous burden, particularly on a developmental state, and is particularly problematic in South Africa in the context of service delivery protests, land invasions and vandalism. It is reported to have been the basis of at least part of the claim in the Swiss case (where the tribunal reportedly found against the Government).

This may well explain the approach taken by the Government in section 7 of the Bill (Protection of investments) which provides that the state must provide foreign investors with an *“equal level of security as may be provided to other investors and subject to available resources and capacity”*. It goes on to provide that all investors (i.e. both foreign and domestic) shall be treated equally in terms of compensation or restitution for loss or damage arising from war, insurrection, revolt etc. In other words - no special treatment is afforded to foreign investors. The vestigial tale of the traditional BIT principle is that the section provides that foreign investors are entitled to compensation where their property is requisitioned or destroyed by “forces or authorities” of the state.

Dispute resolution

A cornerstone of BITs worldwide has been recourse to international arbitration for the settlement of disputes. Risk averse foreign investors tend to have concerns that they will not receive equal treatment before the courts of a foreign country, particularly where they are in a dispute with the government of that country. Whether well founded or not, these fears can have a negative effect on investment decisions. By taking the process for resolution of disputes outside the host nation to an ostensibly neutral arbitral tribunal, the foreign investor can have a greater degree of comfort that it will receive equal treatment and, importantly, privacy. Unlike the traditional approach adopted in BITs, the Bill does not expressly provide for international arbitration. It is not expressly excluded, but it is unlikely to be available to foreign investors. In section 11, the Bill provides for an initial process of mediation, at the election of the foreign investor. However, it goes on to provide that the Minister shall promulgate regulation governing the mediation process. It remains to be seen what the regulations say but, by way of example, certain South African regulations promulgated in respect of the mediation of domestic tax disputes provide for the Government to appoint the mediator, who may be a government employee.

What may appear to be greater protection to the foreign investor is section 11(5), which provides that an investor may refer a dispute to arbitration under the Arbitration Act. However, the Act provides that where the parties to a dispute fail to agree on the arbitrator to be appointed,

either party may apply to the South African courts. Given the Government’s antithetical stance on international arbitration in public statements (to the effect that international arbitration “circumvents” domestic courts) it is unlikely that it will agree to international arbitration. Foreign investors will therefore find themselves subject to the determination of the domestic courts on whether to appoint an international or domestic arbitrator.

Further Down the Investment Road

The Bill is still in draft form and is open to public comment until 1 February 2014. The Government will then need to publish the Bill itself and steer it through the legislative process before it becomes law. Once the Bill becomes an Act which is in effect, it is not entirely clear how it is meant to co-exist with BITs which are still in effect or the transitional protections under terminated BITs. Transitional arrangements under most treaties continue to provide treaty protection for investments made before termination of the treaty for periods of typically 10 - 20 years. So, from a treaty perspective, existing foreign investors will continue to receive the benefit of treaty protection for some time to come but new foreign investors will not. Section 4 of the Bill provides that it applies to an investment made before or after the Bill becomes law. It is unclear what the Government’s intention is here but, in the absence of any change to the treaties themselves, they should continue to prevail over the Bill (or the Act once it becomes law). In the event of a conflict between a BIT and the Bill, the former should either prevail or, if not, a foreign investor may have a claim for breach of the relevant treaty.

An aspect of BITs, to which the Government has not given as much attention publicly, is that they are double edged swords - they afford protections to investors from each country signing a treaty. This may be fairly academic between South Africa and most European countries, as the preponderance of investment has been one way - into South Africa. But in the context of Africa, the Government will need to bear in mind the needs of its own investors. South African companies and financial institutions are significant investors in Africa. When the boot is on the other foot, domestic legislation may not appear quite as attractive.