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Perspectives on topical foreign direct investment issues

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Denying the benefits of the Energy Charter Treaty: Shifting the policy or just the burden of proof?

by

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The modernization of the Energy Charter Treaty (ECT) commenced in November 2017 with the Energy Charter Conference declaration in Ashgabat and aims at a "full scale amendment of the ECT." The main issues are the definition of investment, investor and the scope of certain standards of protection; the right to regulate; the MFN clause; the denial-of-benefits clause; the valuation of damages; third-party funding; sustainable development; and corporate social responsibility. Although this process is not as transparent as stakeholders would have wished, leaked cables allow to make some preliminary observations.

The ECT's modernization responds to the need to keep up with, *inter alia*, changes in the target of energy investments and how certain policies (e.g., the 2019 EU Clean Energy Package) will affect the ECT's scope and coverage. It also needs to consider tribunals' evolving practice and criticism related to it. The modernization process is also likely to ponder the effects of the *Achmea* and of the *Komstroy* judgments on the intra-EU application of the ECT.

As mentioned, one important topic is the reform of the denial-of-benefits clause in Article 17, which respondent parties have increasingly invoked in recent years.

The purpose of denial-of-benefits clauses is to guarantee protection against the abuse of rights and safeguards of the principle of reciprocity embodied in investment treaties by excluding from the protection afforded by the applicable treaty investors or investments that only formally meet the applicable requirements. The denial-of-benefits clause in the ECT excludes from the protection of the treaty (i) investors that are owned or controlled by a legal entity of a third state that do not have substantial business activities in their home contracting party; and (ii) investments by investors of third countries with which the respondent has no diplomatic relations or against which it has imposed economic sanctions.

At present, the predominant view of the ECT contracting parties is to include in the definition of "investor" (Article 1(7)) the requirement that the investor must have "substantive business activities" in the territory of the home contracting party currently stipulated by Article 17.[1] The suggested amendment stems from the fact that the denial-of-benefits clause has rarely been upheld by arbitral tribunals and onerously burdens respondents (see, e.g., *Amto v. Ukraine*). The consequences of this "swap" are significant. First, scenario (i) mentioned above will be erased if the "substantial business activity" requirement is moved to Article 1(7). Second, the proposed change would shift the burden of demonstrating that investors have "substantive business activities" in their home countries onto claimants.[2]

As mentioned in a previous *Perspective*, a "substantive business activity" requirement to access ECT protection also signals that contracting parties are shifting their policy away from the promotion and protection toward the regulation of investment. This change, arguably, may also be procedurally appropriate: investors are better placed to document their activities in the contracting parties in which they are organized.

This change however comes without an "instruction manual".[3] Unlike other modern investment treaties, such as the 2019 Dutch Model BIT, the ECT modernization draft contains no explanation of how to assess the "substantive activity" of investors in a home contracting party.

An exhaustive definition of "substantive business activity" may not be possible, nor desirable, as each business should be assessed on a case-by-case basis. A better solution would be the one proposed in the Dutch Model BIT, namely, to develop a list of non-exhaustive "indicators" to assist in determining the existence of substantive business activities in the home country. These may include: (i) the registration and existence of an office, administration, headquarters, and/or management in the home country, (ii) the number of employees and their qualifications, (iii) the turnover generated in the home country, and (iv) production facilities and/or research laboratories located there. Other issues to be decided are whether such indicators should be assessed individually or globally and whether they should be read cumulatively or alternatively. ECT contracting parties could also find guidance in tax law, where certain jurisdictions (e.g., the U.S.) apply the "substance-over-form" doctrine to prevent the use of artificial structures for tax-avoidance purposes. Going a step further, one can wonder whether the above-mentioned principle of reciprocity could be better achieved by requiring investors to show that they are ultimately owned or controlled by citizens or nationals of an ECT Contracting Party, rather than by showing a "substantive business activity".

The recent round of ECT discussions saw negotiations about various issues, including about the definition of investor and the denial-of-benefits clause. However, it remains unclear whether consensus has been reached. In any event, additional guidance to assess "substantive business activity" would increase certainty and clarity, in particular where complex corporate structures may trigger concerns of the ECT's coverage.

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[1] The proposal also contemplates changing the term "substantial" to "substantive".

[2] Tribunals have only recently held that respondents validly invoked the denial-of-benefits clause; see *Littop Enterprises Limited and others v. Ukraine*, Final Award, 4 February 2021, para. 639.

[3] The "substantive business activity" test, as is, risks to be excessively abstract and criticized on the same grounds as the "contribution to the development of the host state" criterion proposed by the *Salini* test.

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