

Arbitration Alert

# Bull in a China Shop?

## The investor-State dispute settlement provisions of the China-Australia Free Trade Agreement

### KEY POINTS

- The recently signed China-Australia Free Trade Agreement (**ChAFTA**) contains Investor-State Dispute Settlement (**ISDS**) provisions which protect investors from discriminatory treatment, subject to a number of limitations.
- Australian investors in China, and Chinese investors in Australia, need to understand the scope and relative limitations of the ISDS mechanism, which as currently drafted is quite narrow.
- The ISDS mechanism contains provisions designed to preserve the States' freedom of action in matters of public policy such as health and the environment, but it remains to be seen whether that will allay public concerns about the appropriateness of ISDS clauses in investment treaties and free trade agreements.
- China and Australia will continue to negotiate over other standards typically contained in investment treaties (such as prohibitions on expropriation) and they may be included in future, so potential investors should stay close to developments in this area.

### The China-Australia Free Trade Agreement

The China-Australia Free Trade Agreement (**ChAFTA**) was signed on 17 June 2015. On that date, the text of the agreement was also released publicly for the first time. ChAFTA will not come into force until the completion of domestic implementation processes by each State, including (in Australia) review by the Commonwealth Joint Standing Committee on Treaties and the passage of domestic legislation. ChAFTA also provides that additional matters will be the subject of negotiation *after* it has come into force.

ChAFTA has many implications for Australian and Chinese businesses and investors, given the significant trade and investment flows between the two countries.

This update focuses on the investor protection and ISDS provisions of ChAFTA (contained in Chapter 9). Understanding these provisions is important because:

- they have the potential to provide a safeguard for investors against discriminatory or arbitrary state action. They may often be the only route for an investor to obtain compensation for such action.
- investors need to be mindful of the limitations on the particular ISDS mechanism in taking investment decisions and planning to mitigate the risk of state action affecting their investments.

### The controversy over ISDS mechanisms

ISDS mechanisms permit investors from one State to bring a claim against another State in an arbitration, to enforce obligations arising under bilateral/multilateral investment treaties and free trade agreements.

There are a wide range of ISDS mechanisms and underlying obligations, but claims frequently concern:

- discriminatory treatment (treating the investor less favourably than similarly situated nationals);
- expropriation of assets; and
- failure to accord "fair and equitable treatment" to investors.

Although once viewed favourably for providing valuable protections for investments in developing countries, ISDS mechanisms are now somewhat controversial in Australia and many other countries. Among other things, there is a concern that they may prevent, or impose significant costs on, governments attempting to regulate on public interest grounds, including on matters of high public policy such as health and the environment.

The Australian debate about ISDS mechanisms was sparked in 2011, when Philip Morris brought a claim against the Commonwealth of Australia under the Australia-Hong Kong Bilateral Investment Treaty. Philip Morris alleged that the tobacco plain packaging legislation amounted to an expropriation of property and breached various obligations under the treaty.

In 2011, the then Labor Government announced that it would no longer include ISDS mechanisms in treaties and free trade agreements.

The Coalition Government's policy is that it will consider ISDS provisions on a case by case basis. Along with recent agreements such as the 2014 Korea-Australia Free Trade Agreement (which includes more specific investor protections and permits a wider range of disputes to be referred to arbitration, with a similar dispute resolution process but one which does not include some of the provisions in ChAFTA which restrict claims touching on matters of public policy), ChAFTA is an important indicator of how the Coalition will approach ISDS provisions in other agreements currently under negotiation, such as the Trans-Pacific Partnership.

### **States' obligations**

Under Chapter 9 of ChAFTA, the States assume obligations only in respect of investments by persons of one State in the territory of the other. Whilst "investment" is broadly defined, the mechanism does not cover ordinary trading in goods or services absent an investment, although the parties will negotiate over the application of the regime to "services supplied through commercial presence".

The Chapter presently only imposes the following substantive obligations on Australia and China:

- that investors from the other State be treated no less favourably than nationals in like circumstances (National Treatment – Article 9.3).
- most-favoured nation treatment (Article 9.4).

These protections do not apply to things done prior to the entry into force of ChAFTA and do not apply to a number of specific measures and policy areas.

The parties have agreed in Article 9.9 to negotiate, following a review which will take place over the next three years, further provisions which will address matters including:

- minimum standards of treatment;
- expropriation;
- transfers; and
- performance requirements.

These standards, and their precise terms, are often critical to investor-State disputes. Until these further articles have been agreed, it is difficult to know how extensive investors' rights will be.

In the meantime, the existing Australia-China Bilateral Investment Treaty contains additional investor protections but also has limited dispute resolution provisions. Importantly for investors, however, it does allow for investor-State arbitration for claims relating to expropriation. Where it applies, the Treaty may provide additional protections for investors. Its status and relationship with ChAFTA will be considered as part of the review and negotiations required by Article 9.9.

### **States' entitlement to regulate on public policy grounds**

Article 9.8 confirms that nothing in ChAFTA will prevent a State from adopting or enforcing measures:

- necessary to protect human, animal or plant life or health (including environmental measures);
- necessary to ensure compliance with laws and regulations consistent with ChAFTA;
- for the protection of national treasures; or
- relating to the conservation of exhaustible natural resources (including environmental measures),

provided such measures are not applied in a discriminatory manner or a disguised restriction on international trade and investment.

This article is likely intended to address public concern about ISDS mechanisms. Given that there will frequently be room for argument about discriminatory application or the true purpose of regulatory regimes, however, it is not clear whether it will significantly constrain the scope for investor-State disputes.

### **The dispute resolution procedure: key features**

The dispute resolution procedure only covers claims for breaches of Article 9.3 (National Treatment) which result in alleged loss or damage. It may well, though, be broadened as further investor protection standards are negotiated over time under Article 9.9.

ChAFTA provides for a compulsory negotiation or "consultation" to take place between the investor and State, to be followed if necessary by an arbitration under (at the investor's election):

- the International Centre for the Settlement of Investment Disputes (**ICSID**) Convention and ICSID Rules;
- the ICSID Additional Facility Rules;
- the UNCITRAL Arbitration rules with certain modifications; or
- any other arbitral body or rules, if the parties agree.

The rules specify that, with certain exceptions, much of the arbitral proceeding shall be conducted in public. There are also provisions for non-parties (which may include interest groups) to make submissions as "friends of the court". These features mean that there will be a relatively high degree of transparency concerning disputes under ChAFTA compared to many other arbitral regimes.

Importantly, measures that are "non-discriminatory and for the legitimate public welfare objectives of public health, safety, the environment, public morals

### **Contacts**



**Georgia Quick**  
Partner  
Sydney  
T: +61 2 9258 6141  
E: georgia.quick@ashurst.com



**Mark Bradley**  
Senior Associate  
Melbourne  
T: +61 3 9679 3363  
E: mark.bradley@ashurst.com

or public" cannot be the subject of a claim (Article 9.11(4)).

China and Australia may agree that a measure is non-discriminatory and for a legitimate public welfare objective, and inform the investor of their view (Article 9.11(5)-(8)). The legal consequences of the parties taking a joint position are unclear, but in practice it would be likely to make it difficult or risky for an investor to proceed with a claim.

There is also provision for such claims to be subject to preliminary objections and disposed of promptly (Article 9.16(5)-(6)).

### **WHAT YOU NEED TO KNOW**

- Whilst investor-State arbitrations are relatively rare, the possibility of bringing such claims provides a significant protection for investors and deters States from discriminatory or arbitrary conduct.
- The ISDS mechanism in ChAFTA provides important protections against discriminatory treatment for Australian investors in China and Chinese investors in Australia.
- However, other protections which are typically found in investment treaties remain to be negotiated and the degree of protection which ChAFTA will ultimately offer is therefore quite uncertain. In the interests of investment certainty, it is hoped that this will be clarified as quickly as possible.
- Moreover, there are provisions in the ISDS which seek to highlight or expand the powers of each State to regulate in the public interest. This may go some way to allaying public concern about the effect of ISDS mechanisms on matters of public policy.

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## Key Contacts - Arbitration

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### EUROPE

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#### United Kingdom

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Ronnie King	Partner	+44 (0)20 7859 1565	<a href="mailto:ronnie.king@ashurst.com">ronnie.king@ashurst.com</a>
Mark Clarke	Partner	+44 (0)20 7859 1562	<a href="mailto:mark.clarke@ashurst.com">mark.clarke@ashurst.com</a>
Tom Cummins	Partner	+44 (0)20 7859 1051	<a href="mailto:tom.cummins@ashurst.com">tom.cummins@ashurst.com</a>
Dyfan Owen	Partner	+44 (0)20 7859 1176	<a href="mailto:dyfan.owen@ashurst.com">dyfan.owen@ashurst.com</a>
Tim Reid	Partner	+44 (0)20 7859 1548	<a href="mailto:tim.reid@ashurst.com">tim.reid@ashurst.com</a>

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#### France

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Eric Bouffard	Partner	+33 1 53 53 54 73	<a href="mailto:eric.bouffard@ashurst.com">eric.bouffard@ashurst.com</a>
Jean-Pierre Farges	Avocat à la Cour	+33 1 53 53 53 71	<a href="mailto:jean-pierre.farges@ashurst.com">jean-pierre.farges@ashurst.com</a>

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#### Germany

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Philipp Beckers	Counsel	+49 (0)89 24 44 21 129	<a href="mailto:philipp.beckers@ashurst.com">philipp.beckers@ashurst.com</a>
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#### Spain

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Gonzalo Jiménez-Blanco	Partner	+34 91 364 9845	<a href="mailto:gonzalo.jimenez-blanco@ashurst.com">gonzalo.jimenez-blanco@ashurst.com</a>
José Antonio Rodríguez	Partner	+34 91 364 9431	<a href="mailto:joseantonio.rodriquez@ashurst.com">joseantonio.rodriquez@ashurst.com</a>

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### ASIA PACIFIC

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#### Australia

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Jeremy Chenoweth	Partner	+61 7 3259 7028	<a href="mailto:jeremy.chenoweth@ashurst.com">jeremy.chenoweth@ashurst.com</a>
Georgia Quick	Partner	+61 2 9258 6141	<a href="mailto:georgia.quick@ashurst.com">georgia.quick@ashurst.com</a>
Peter Voss	Partner	+61 2 9258 6090	<a href="mailto:peter.voss@ashurst.com">peter.voss@ashurst.com</a>
Peter Ward	Partner	+61 8 9366 8163	<a href="mailto:peter.ward@ashurst.com">peter.ward@ashurst.com</a>

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#### Hong Kong

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Gareth Hughes	Partner	+852 2846 8963	<a href="mailto:gareth.hughes@ashurst.com">gareth.hughes@ashurst.com</a>
Angus Ross	Partner	+852 2846 8909	<a href="mailto:angus.ross@ashurst.com">angus.ross@ashurst.com</a>

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#### Indonesia

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Debby Sulaiman	Partner	+62 212 996 9200	<a href="mailto:debby.sulaiman@oentoengsuria.com">debby.sulaiman@oentoengsuria.com</a>
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#### Singapore

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Ben Giaretta	Partner	+65 6416 3353	<a href="mailto:ben.giaretta@ashurst.com">ben.giaretta@ashurst.com</a>
Rob Palmer	Partner	+65 6416 9504	<a href="mailto:rob.palmer@ashurst.com">rob.palmer@ashurst.com</a>

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