Kluwer Arbitration Blog

Resolving Disputes Amidst Japan-Korea Trade and Investment Tensions: Part I

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1. Complex Multi-faceted Tensions between Japan and Korea

A media and geopolitical storm recently erupted after Japan introduced measures affecting exports to the Republic of Korea (***Korea***). Thunder sounded with Japan's imposition of certification requirements on three chemicals needed by South Korean companies to make semiconductors, memory chips and displays for consumer electronics (the ***4 July Measure***). This was followed by lightning and rain when Japan removed Korea from its "white list" of trusted trading partners (the ***2 August Measure***), then threats by Seoul to retaliate by reducing military-intelligence cooperation and imposing countermeasures on trade. The growing tempest has brought about the worst breakdown in cross-border bilateral relations in five decades, generating both regional and global ramifications.

Differing rationales for the geopolitical storm have been given. The Japanese government and media tend to emphasise security concerns, namely on-shipments of such chemicals with potential military applications to North Korea, violating multilateral sanctions. The South Korean government and media, as well as some international news outlets, have often placed more emphasis on the possibility of Japan "retaliating" for an October 2018 judgment of the Supreme Court of Korea. That decision upheld lower court judgments from 2014 finding major Japanese companies, such as Nippon Steel, liable to compensate claimants alleging that they were forced labourers for the Japanese companies during World War 2. The companies, and the Japanese government, have argued that such claims were precluded by a bilateral treaty signed in 1965 to restore diplomatic relations. (Similar claims and defences but under different bilateral instruments have been raised before Japanese courts by Chinese war-time labourers, generating a settlement with Nishimatsu group companies.) A few media reports also speculate that Japan introduced export restrictions affecting Korea to bolster the appeal of the Abe Administration in upper House of Councillor elections, but it secured another solid victory anyway. Some media sources suggest that populist Korean President Moon Jae-in may be "playing to the base" too in domestic politics.

Introducing trade-restrictive measures, however, raises the potential for Korea to complain before the World Trade Organization (***WTO***). It brings to mind the claim successfully brought by the Obama Administration against China over 2012-14, resulting in China removing export duties and quotas imposed on rare earths, for which it similarly controlled almost all world trade. However, the general exceptions China failed to establish in that case, under Article XX of the General

Agreement on Tariffs and Trade (***GATT***), dealt with health and conservation of natural resources. By contrast, Japan here could be expected to raise national security exceptions under Article XXI. There are even greater differences from a procedural perspective, which we focus on below. If indeed Korea files a formal complaint and an ad hoc panel rules against Japan, this would only come by next year at the earliest. By then the Appellate Body will likely lack sufficient members (full-time "judges"), due to the Trump Administration blocking new appointments until its concerns about dispute resolution and other aspects of the WTO system are adequately addressed. Accordingly, Japan could appeal any panel decision allowing retaliation for any GATT violations found, and then never come under pressure to remove or adjust its measures against Korea.

The situation becomes even messier when we consider below other potential inter-state dispute resolution processes. Japan could seek arbitration under the 1965 treaty, but that effectively requires the counterparty to provide further consent, which Korea does not seem to want to do. Japan might also consider litigating the treaty before the International Court of Justice (***ICJ***). Another option is to invoke inter-state arbitration under the Japan-Korea bilateral investment treaty (***BIT***) in force since 2003, and/or a trilateral investment treaty including China in force from 2014, underpinning cross-border relations among Asia's three largest FDI providers. However, it may be difficult to prove that the Korean court judgments involved a procedural defect or discrimination towards the Japanese companies creating a denial of justice, contrary to the relevant treaty.

Part II in a separate posting will analyse a further possibility: the Japanese companies might directly initiate investor-state dispute settlement (***ISDS***) claims, as provided by both investment treaties in lieu of inter-state arbitration. This could theoretically include an application to the ad hoc arbitration tribunal to issue interim measures preventing enforcement of the Korean Supreme Court ruling, until the tribunal had finally determined claims such as denial of justice. However, this dispute resolution option generates legal and practical problems for the Japanese companies themselves, and the Japanese government due to some renewed sensitivity recently over ISDS in general. Because of these multi-faceted potential disputes, involving various treaties and parties, we will end by urging formal mediation to assist achieving a global settlement.

2. Japan vs Korea Under the 1965 Treaty or Investment Agreements

Procedural as well as substantive law complications arise under the 1965 Japan and Korea Treaty on Basic Relations. It purports to settle and foreclose claims related to the treatment of Korean nationals during the period of Japanese colonial rule before World War 2 in exchange for a payment by Japan to Korea of USD 2.5 billion (in today's terms) and an offer of favourable loans to Korea. Japan and Korea disagree about whether the treaty was meant to settle only state-level claims or to also extend to private claims by Korean labourers against Japanese businesses.

Article III provides that disputes over treaty interpretation can be settled in inter-state arbitration should diplomatic consultations fail. Although Japan invoked this provision on 20 May 2019, after consultations following Korean court execution orders against Japanese companies, Korea has not consented to arbitrate or selected an arbitrator under the terms of the treaty. This effectively closes the door on the possibility as there is no authority named in the treaty for default appointments of party arbitrators. While Korea's non-compliance with the arbitration provision may raise the issue of good faith under general international law in principle, the practical consequence for now is that arbitration is stalled, although Japan still seems to hold out hope that the Korean government will

change its course.

Japan has also said it is considering bringing the 1965 treaty dispute to the ICJ. Like arbitration, this option would require Korea's consent because, unlike Japan, Korea has not made a declaration that the jurisdiction of the ICJ is compulsory or elsewhere consented to give the Court authority over the dispute. While proceedings before the ICJ raise a different set of procedural considerations – including relative efficiency, confidentiality, and access to provisional measures – it is unclear why Korea would be more open to this alternative than arbitration if Japan were to move to institute proceedings.

Japan could therefore instead make collateral claims under the 2002 Japan-Korea BIT or the 2012 trilateral investment agreement between China, Japan and Korea, although the Japanese government does not seem to have raised this possibility publicly. Both instruments were in force when the dispute arose and each provides for mandatory inter-state arbitration supported by appointing authorities to act for non-participating parties.

Article 14 of the BIT would allow Japan to commence UNCITRAL Rules (ad hoc) arbitration against Korea. It usefully adds an expedited procedure for submissions, hearings, and drafting of the arbitral award, but envisages first "consultations" without specifying any time limit beyond which arbitration can be commenced. Japan may also be disconcerted that there is no express elaboration of a "loser pays" principle, as has become more common (although far from uniform) in international commercial and even investor-state arbitration. The starting point under the BIT is instead that each state bears costs equally, whatever the outcome, subject to tribunal discretion.

Under the trilateral agreement, Article 17 provides that Japan can commence arbitration under the UNCITRAL Arbitration Rules after a mandatory consultation period of six months beginning with a written request for consultations. The scope of the written request, concerning "any dispute relating to the interpretation or application of [the trilateral agreement]," may not be broad enough to include Japan's request for consultations under the 1965 treaty on 9 January 2019. Assuming notice is not a hurdle, the arbitration procedure mostly mirrors the expedited process and division of costs terms found in the BIT. The most significant difference is that China would be permitted to make submissions and attend hearings as a right.

Apart from these procedural issues, arbitration under an investment treaty may not be attractive to Japan as it could narrow the scope of possible claims. Rather than deal directly with the questions of interpretation of the 1965 treaty, the arbitration would concern whether the Korean judiciary breached standards of treatment in the investment treaty by holding Japanese companies liable for forced labour. The standards for resolving this question are expressed differently in the instruments. The BIT promises state treatment that is fair and equitable without qualification while the trilateral agreement links fair and equitable treatment of investors to "generally accepted rules of international law" and goes on to stipulate that "a determination that there has been a breach of… a separate international agreement, does not ipso facto establish that there has been a breach [of the investment treaty]." Based on the broader treatment standard and indefinite consultation period, the BIT may offer a better option for Japan.

To prevail under either investment treaty, Japan would likely have to demonstrate serious procedural irregularities or prove that the Korean Supreme Court's ruling was discriminatory and not merely that the court misinterpreted the terms of the 1965 treaty in reaching its judgment. There are a few public examples of investors challenging court judgments successfully on the basis

of protections in investment treaties. Chevron notably convinced an investment tribunal to stay a 9.5 billion USD Ecuadorian court judgement against the company and ultimately recovered damages for denial of justice under the Ecuador-U.S. BIT and violations of customary international law. Yet the fit with the dispute between Japan and Korea is far from perfect. While the Chevron tribunal found that the court judgment was written by a third party in exchange for payment to the judge, there have been no such allegations of corruption against the Korean courts.

Even if Japan were to convince a tribunal that its nationals were denied justice by the Korean courts, the tribunal would not necessarily have to interpret the 1965 treaty to resolve the claims. Absent a ruling on the meaning of the treaty, the root cause of the dispute would remain unsettled.

3. Korea vs Japan in the WTO

So far, Korea has not filed any formal complaint under the WTO's Dispute Settlement Understanding (***DSU***). In force from 1995, that allows an affected member state first to seek bilateral consultations, then request formation of panel of three ad hoc decision-makers, and then appeal any adverse ruling to the Appellate Body for review by a minimum of three "judges". However, Korea instead has so far raised its concerns in this case to the WTO General Council, the WTO's highest decision-making body comprising representatives of all member states. Korea may be seeking to raise wider awareness among them about the bilateral tension and thereby prompt an informal diplomatic solution, but raising matters in this forum could entrench positions. If Korea does file a formal complaint through the DSU, issues anyway are complicated in terms of substantive WTO law and especially under the current WTO dispute settlement regime.

We elaborate elsewhere the substantive issues. In short, Korea will claim that Japan's 4 July Measure violates the Most-Favoured-Nation rule in GATT Article I because exports to other WTO Members of the three chemicals receive an advantage in the form of the expedited export facilitated by the bulk licences and that advantage is not extended to exports to Korea. It could similarly complain about the 2 August Measure, removing Korea from the white list of countries receiving less onerous treatment from Japan in relation to controls over exports of a broad range of goods.

Japan might then claim justification for both measures under GATT Article XXI, allowing a state to take "any action which it considers necessary for the protection of its essential security interests". A recent WTO panel decision in one of several disputes between Russia and Ukraine, found that this exception is not completely "self-judging" (as asserted by Russia, as well as generally the USA,) so it had jurisdiction to examine the measures that Russia claimed were to protect its security. But the panel nonetheless found them justifiable, applying a two-step test.

If Korea does bring a WTO claim and Japan raises this particular security exception, a new ad hoc panel formed may not follow such legal reasoning and factual determinations may be difficult. There is further uncertainty because although the Russia-Ukraine panel decision was appealed, the Appellate Body is understaffed and cannot deal with it this year.

That understaffing points to an ever bigger, procedural problem for Korea. Even if it prevails on the merits before a WTO panel, this is unlikely to occur before next year. By then, however, another of the three remaining Appellate Body judges will have reached mandatory retirement. If the USA keeps objecting to any new appointments because of various objections to the DSU

procedures and the wider WTO system, the Body will lack a quorum to decide any appeals, including for example by Japan if unhappy with the earlier ad hoc Panel. In other words, Korea will have achieved only a pyrrhic victory.

Various WTO members are trying to resolve the DSU breakdown. For example, the EU proposed amendments to the DSU in late 2018 that attracted support from Australia and Korea, but the USA was not persuaded. The EU and China apparently criticised April 2019 proposals by Australia and Japan as being too soft on the USA. China's views towards the WTO dispute settlement system are unclear, after recently withdrawing from panel proceedings against the EU's anti-dumping duties.

There are ongoing discussions for back-up plans whereby member states agree not to appeal or to substitute the usual two-tier DSU process with inter-state arbitration under DSU Article 25, rarely used since 1995 (as discussed on this blog here). But these plans are complicated and involve states opting in to a new dispute settlement regime. Such deep uncertainties over inter-state dispute resolution procedures further cloud the picture regarding a potential WTO claim by Korea against Japan.

To conclude so far, Japan can probably fend off WTO claims by Korea. However, on substantive and/or procedural grounds, Korea probably has a good chance of fending off claims brought by Japan under the two applicable investment agreements and the 1965 treaty. This leaves questions over potential investment agreement claims by affected Japanese companies, creating further complications and enhancing the need to try formal mediation, as we explain in our forthcoming related posting.

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