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ITA Roundtable at UNCITRAL Working Group III: Draft Provision 17 and the Denial of Benefits Clause

Florian Haugeneder, Daniela Bartsch (KNOETZL) · Saturday, November 23rd, 2024 · Institute for Transnational Arbitration (ITA)

On 23 September 2024, the third ITA Roundtable at an UNCITRAL Working Group III ("UNCITRAL WG III") session took place at the offices of KNOETZL. Anna Joubin-Bret, Secretary of UNCITRAL, and Jurgita Petkute, Partner at KNOETZL, gave introductory remarks. Dr. Crina Baltag from Stockholm University moderated the discussion of the panel consisting of Lorena Fatás (State Attorney, Deputy-Head International Arbitration Department, State's Attorney Office, Kingdom of Spain), Florian Haugeneder (Partner, KNOETZL), Professor Dr. August Reinisch (University of Vienna), and Tom Sikora (Senior Counsel, Exxon Mobil Corporation).

The UNCITRAL WG III continues the consultations on Draft Provisions concerning procedural reform, which have been updated in UNCITRAL working paper A/CN.9/WG.III/WP.244. The focus of this ITA roundtable discussion was on Draft Provision 17, which addresses the "denial of benefits" clause, which allows States to deny the protection offered to investors or investments under the following circumstances:

> Draft Provision 17: Denial of benefits
> 1. A Contracting Party may deny the benefits of the Agreement to an investor of the other Contracting Party that is an enterprise of that Contracting Party and to investments of that investor if the enterprise is owned or controlled by a person of a non-Contracting Party and:
> (a) The enterprise has no substantial business activities in the territory of any Contracting Party other than the denying Contracting Party; or
> (b) The denying Contracting Party adopts or maintains measures with respect to the non-Contracting Party or a person of the non-Contracting Party that prohibit transactions with the enterprise or that would be violated or circumvented if the benefits of the Agreement were accorded to the enterprise or to its investments.
> 2. A Contracting Party may deny the benefits of the Agreement to an investor of the other Contracting Party and to investments of that investor if:
> (a) The investor receives third-party funding in a manner inconsistent with Draft Provision 12;
> (b) The investment was made in violation of the denying Contracting Party's laws and regulations;
> (c) The investment involved or was made by way of corruption, fraud, or deceitful

> conduct; or
> (d) The claim would constitute a misuse of the Agreement and its objectives.

I. The Rationale Behind Denial of Benefits Clauses

August Reinisch kicked off the discussion by elaborating on the rationale behind denial of benefits clauses in investment treaties. He explained that the original idea behind denial of benefits clauses is to prevent shell companies without a genuine investment activity in a contracting State and economically sanctioned parties from deriving benefits under an investment protection instrument. There is a need for reform as arbitral tribunals have interpreted denial of benefits clauses differently, particularly with regard to aspects such as the timing and form of the notification of the denial of benefits, the burden of proof regarding the conditions of their application, and the meaning of "owned" and "controlled" with respect to an investment. August Reinisch noted that the current draft of Article 17 does not address these questions.

Crina Baltag noted that the reasoning in legal literature for having denial of benefits clauses was "not only as a guarantee against the abuse of rights but also as a safety measure for safeguarding the principle of reciprocity embodied in investment treaties." It can therefore be seen as a procedural tool guaranteeing that treaties are not misused, but at the same time acknowledging that treaties are in the policy sphere of States. She added that, with the modernisation of the Energy Charter Treaty's denial of benefits provision 17, some elements regarding "substantial business activity" have been inserted. Similarly, the CETA, the Indian Model BIT and the Dutch Model BIT offer some definitions of "substantial business activity" and "control".

II. Denial of Benefits: A Look Into the Practice

Turning to international investment arbitration practice, the panellists shared their experiences on how (and with what success) denial of benefits clauses were invoked in investment arbitrations.

Lorena Fatás gave an overview of her experience from the States' perspective. She outlined that the challenge when invoking a denial of benefits clause relates to the timing of when the benefits should be denied (*i.e.*, before the investment is made or before the dispute arises). In case the burden of proof lies with the State, it is challenging to prove that there has not been a "substantial business activity" in a contracting State. In practice, States face great difficulties when seeking to deny benefits even where there is an obvious absence of substantial business activity in a contracting State.

Tom Sikora focused on Draft Provision 17 from the investors' perspective. He emphasized that guidance regarding denial of benefits would be valuable. He noted that in his opinion denial of benefits is not a procedural issue but a substantive one. Therefore, he questioned if harmonization is needed as States presumably are of the opinion that denial of benefits should be left to the policies of each individual State. Regarding Draft Provision 17, he listed four aspects that would merit consideration as they are not covered by the current draft: (i) the timing of the notification of denial of benefits, *i.e.*, the question of whether denial of benefits has to be invoked before or after the dispute has arisen, (ii) whether the denial of benefits applies prospectively or retrospectively,

(iii) whether the denial of benefits is a jurisdictional or a merits issue and (iv) more clarity on the meaning of "substantial business activity".

Florian Haugeneder raised the concern that the wording of Draft Provision 17, according to which States "may" deny benefits, stands in stark contrast to the requirement of the predictability of the investment regime, which is a cornerstone of the attractiveness of investment treaty protection. If States have discretion about the invocation of the denial of benefits clause, this creates uncertainty for investors. As the policy goals of denial of benefits clauses can also be achieved by defining access to treaty protection, it is questionable whether denial of benefits clauses are necessary at all.

Florian Haugeneder went on to give an overview of the critical elements of Draft Provision 17, in particular its second paragraph. The investments covered by paragraphs 2(b) (investments made in violation of the denying Contracting Party's laws and regulations) and 2(c) (investments made by way of corruption, fraud, or deceitful conduct) would normally not be protected as they would typically be excluded by "in accordance with the law" requirements contained in the definition of investment. The second type of situation covered by paragraphs 2(a) (third-party funding in a manner inconsistent with Draft Provision 12) and 2(d) (misuse of the Agreement and its objectives) of Draft Provision 17 have a somewhat unclear scope and purpose. If the "misuse" under 2(d) means an abuse of rights, the claim would normally not receive treaty protection in any event. If the threshold for an invocation is lower, then the question arises as to how it is defined and how it squares with the predictability and notification requirements. It was put forward that the sanction of denial of benefits for any breach of third-party funding requirements was too draconian and the sanctions contained Draft Provision 12 were likely sufficient.

August Reinisch followed up on the discretionary wording of "may deny" and clarified that the wording does not make it a completely self-judging clause. There were objective criteria that had to be met before States could invoke a denial of benefits. Regarding the question of whether the denial of benefits clause is a jurisdictional or merits issue, he referred to the Annotation of the Draft Provisions and argued that the wording of the annotations presupposes that the denial of benefits is a merits issue.

Crina Baltag went on to explain that under the Energy Charter Treaty, arbitral tribunals have held that the denial of benefits clause does not apply automatically but is a right that must be exercised. Draft Provision 17 does not contain any specifications on notification and the timing of the exercise of that right, whereas, for example, the NAFTA provision on denial of benefits contains such requirements.

Lorena Fatás proposed a clarification to the wording of paragraph 2 of Draft Provision 17 to emphasise that paragraph 2 does not contain requirements that need to be met cumulatively with the requirements of paragraph 1. If the notification of the denial of benefits should be made before the dispute arises, Draft Provision 17 poses practical difficulties: there is probably no situation where third-party funding is at issue and a state is able to identify a breach of Draft Provision 12 before the dispute arises. Likewise, breaches of law and issues of corruption normally could not be identified by the State before the dispute was notified.

In response to Crina Baltag's question on the timing of the invocation of a denial of benefits clause, Tom Sikora stated that in recent treaties the denial of benefits can be raised until the statement of defence. However, he preferred to see it in response to a request for arbitration. Finally, with regard to Draft Provision 17, paragraph 2(d), if the current draft is adopted, it would

result in considerable litigation over the meaning of the term “misuse”.

The ITA roundtable discussion has once more proven to be an interesting and useful forum to gather external views from practitioners and academics on draft instruments of UNCITRAL Working Group III. The participants look forward to the next edition in January 2025.

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