

ד"ר אפי חלמיש

Dr. EFRAIM (EFI) CHALAMISH

79 West 12 Street, Apartment #2F • New York, New York 10011

September 22, 2010

Prof. Eytan Sheshinski

Chairman

The Committee on Fiscal Policy w/r/t Oil and Natural Gas in Israel (“Committee”)

Re: The Legal Status of Foreign Investors in Israel and Increases in Royalty Rates and Taxes Applicable to Existing Holders of Petroleum Rights

Background

1. The legal opinion hereby provided to the Committee (“Opinion”) expresses my opinion on the legal rights of foreign investors in the oil and gas industry in Israel with respect to the government’s proposal to unilaterally increase the royalty rate or tax rate these foreign investors are subject to.
2. The Opinion will discuss Israel’s obligations according to customary and conventional international law. The Opinion does not, however, discuss other legal aspects of Israel’s decision to change its gas oil legal regime, such as its obligations in Israeli constitutional law and administrative law. Additionally, the Opinion does not address additional important economic and policy considerations, which should be taken into account during the legislative process, including efficient accumulation and distribution of oil and gas revenues.
3. I am an international lawyer and a professor of international law and international economic law, specializing, among other areas, in international investment law. I have published extensively in this field and have advised various institutions on related matters.

Protection of Foreign Investors in Israel – Absolute and Contingent Standards

4. Gas and Oil exploration and production in Israel is regulated by The Israeli Petroleum Law¹. This law provides investors with economic rights in the form of preliminary permits, licenses and leases². A license is an exclusive right for exploration work that requires the drilling of test wells. Following discovery of petroleum, the licensee has a statutory right to receive a production lease, which provides an exclusive right to explore for and produce petroleum in the lease area. A lessee is subject to 12.5% royalty rate of the quantity of petroleum produced and saved from the lease area (subject to a minimum royalty).

¹ The Israeli Petroleum Law 5712-1952.

² *Id.*, Definitions.

5. The Israeli government has not published any official proposal to modify the petroleum legal regime. Yet, according to public reports, the Committee considers the increase of payments by the existing holders of petroleum rights (“Petroleum Rights”), which include both licenses and leases. Since the existing holders of the Petroleum Rights have invested large financial resources in the Israeli petroleum industry, carrying significant financial risk, based on the existing legal framework, this Opinion examines the legality of any potential changes to the above-mentioned legislation based on Israel’s international legal obligations. I will discuss specifically the status of American investors in Israel given the current ownership structure of the Petroleum Rights, but this analysis can be applied to investors from other nationalities with the appropriate adjustments.
6. Foreign investors in Israel enjoy international protection standards according to customary international law and treaty law. The Friendship, Commerce and Navigation Treaty between the United States in Israel (“US-Israel FCN Treaty”), signed in 1951 and entered into force in 1954, provides U.S. nationals, such as Noble Energy Inc., investment protection while investing in the oil and gas in Israel.
7. The US-Israel FCN Treaty is a reflection of the parties’ strategic and economic relations and an attempt to codify some of the core customary international law principles of that time. As the preamble of the US-Israel FCN Treaty shows, its purpose is “strengthening the bonds of peace and friendship traditionally existing between them and of encouraging closer economic and cultural relations between their peoples, and being cognizant of the contributions which may be made toward these ends by arrangements encouraging mutually beneficial investments, promoting mutually advantageous commercial and cultural intercourse and otherwise establishing mutual rights and privileges...based in general upon the principles of national and of most-favored-nation treatment unconditionally accorded.³”
8. In the 1960 FCN treaties were followed by a new treaty type, Bilateral Investment Treaties (“BITs”), which promote foreign investment from capital-exporting states and protect foreign investors in capital-importing states. As I discuss below, the new treaties included a direct investor-state dispute mechanism which had not been part of the FCN treaties movement.
9. It is important to note at the outset of this analysis that the broad language of the US-Israel FCN Treaty and the emerging jurisprudence of international investment law supports the conclusion that American investors can enjoy this treaty’s protection regardless of the indirect ownership of the economic rights in Israel through other subsidiaries or the fact they own minority stocks and not whole assets. According to investment law jurisprudence shareholders can bring a direct

³ Israel Friendship, Commerce and Navigation Treaty, with Protocol and Exchange of Notes, between the United States of America and Israel, Signed at Washington DC, August 23, 1951, *available at* http://tcc.export.gov/Trade_Agreements/All_Trade_Agreements/exp_005440.asp (unofficial text).

claim against the host state for the loss of their proportionate shareholder value, as long as the ‘investment’ definition is broad enough to express the parties’ consent to protect shareholder value even in a third state⁴. Additionally, the ‘companies’ definition in Article XXII, paragraph 3, of the US-Israel FCN Treaty does not exclude subsidiaries in third states and Article VI, paragraph 3, specifically applies the expropriation provision to both directly and indirectly-controlled assets⁵.

10. The power to regulate and impose or increase taxes is part of the policy power of the state. Modern international investment law jurisprudence is frequently dealing with the question whether a regulatory regime is part of the right to regulate or it is a violation of international law⁶. This Opinion will not provide a comprehensive analysis of the relevant jurisprudence to the case at hand, but will discuss the main obligations the State of Israel is committed to according to customary international law and the US-Israel FCN Treaty. These obligations will be analyzed in light of a proposed regime to increase royalties and/or taxes on foreign investors in the oil and gas industry.
11. International investment law has been developed in recent years through a large number of international arbitration decisions, both investor-state and stat-state, which refer to each other in order to develop a cohesive and harmonized legal system. Nevertheless, a decision by one tribunal does not have the same precedent status like in other legal systems, and many arbitrators in investment disputes explicitly reject their obligation to follow other tribunals’ decisions. The recent decision *Burlington Resources Inc. v. Ecuador* reflects the various opinions on the duties of investment arbitration tribunals to promote consistency in international investment law jurisprudence:
“The Tribunal considers that it is not bound by previous decisions. At the same time, it is of the opinion that it must pay due consideration to earlier decisions of international tribunals. The majority believes that, subject to compelling contrary grounds, it has a duty to adopt solutions established in a series of consistent cases. It also believes that, subject to the specifics of a given treaty and of the circumstances of the actual case, it has a duty to seek to contribute to the harmonious development of investment law, and thereby to meet the legitimate expectations of the community of States and investors towards the certainty of the rule of law. Arbitrator Stern does not analyze the arbitrator's role in the same

⁴ See, e.g., *Lanco International Inc. v. Argentina Republic*, Preliminary Decision on Jurisdiction, (2001) 40 ILM 457, 463; *CMS Gas Transmission Company v. The Republic of Argentina* (ICSID case No. ARB/01/8), Decision on Objections to Jurisdiction, in (2003) 42 ILM 788.

⁵ Section 3 of the Protocol of the US-Israel FCN Treaty. This structure allows investors to take advantage of the legislation of a third country, usually for tax purposes, and simultaneously invest in the host state, with which their home country has signed an investment treaty.

⁶ See, e.g., “*Indirect Expropriation*” and the “*Right to Regulate*” in *International Investment Law*, OECD Working Papers on International Investment, 2004/4.

- manner, as she considers it her duty to decide each case on its own merits, independently of any apparent jurisprudential trend.⁷”
12. According to customary international law, host states⁸ have to provide a minimum standard of treatment, which includes “Fair and Equitable Treatment” and “Full Protection and Security” to their foreign investors. Most investment treaties codify this obligation. The US-Israel FCN Treaty refers to the commitment to “accord equitable treatment”⁹ and “the most constant security”¹⁰, which is understood in modern practice as the equivalent to “Fair and Equitable Treatment” and “Full Protection and Security” standards.
 13. Fair and Equitable Treatment standard (“Fair and Equitable Treatment”) in the various treaties is subject to an ongoing debate whether it is equivalent to the international minimum standard of treatment under customary international law, or if it is an independent standard that can be interpreted separately¹¹. Although this standard is interpreted on a case-by-case basis, it is generally perceived as an application of the rule of law to all branches of domestic government, including national legislator, domestic administration, and domestic courts¹². Consequently, Fair and Equitable Treatment can include, among other obligations, the protection of investor’s legitimate expectations, procedural due process and denial of justice, predictability of the legal system, protection against discrimination and arbitrariness, and commitment to transparency, reasonableness and proportionality¹³.
 14. Therefore, an increase of royalty and tax rates on foreign investors by the Israeli legislator against their expectations at the time of the investment and lack of participation of these investors in the administrative or judicial process are violations of the Fair and Equitable Treatment obligation in customary and treaty law. In order to assess the legitimate expectations of the investors, future tribunals will examine the written and oral commitments of the Israeli government given to its existing holders of Petroleum Rights when they applied for a license or a lease.

⁷ *Burlington Resources Inc. and others v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (PetroEcuador)*, ICSID Case No. ARB/08/5, Decision on Jurisdiction, June 2, 2010, paragraph 100.

⁸ In this Opinion “host state” is the location of the investment and “home state” is the state where the investor is incorporated.

⁹ Article I of the US-Israel FCN Treaty.

¹⁰ Article III(1) and VI(1) of the US-Israel FCN Treaty. These provisions refer to persons and property respectively.

¹¹ For instance, the Free Trade Commission (FTC) interpretive note, dated July 31, 2001, analyzes Article 1105 of NAFTA which provides investors treatment according to minimum standard in international law and concludes that this provision refers to customary international law, which includes fair and equitable treatment and full protection and security.

¹² See Stephan Schill, *Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law* (IILJ Working Paper 2006/6, Global Administrative Law Series), available at <http://www.iilj.org/publications/documents/2006-6-GAL-Schill-web.pdf> (last visited September 22, 2010).

¹³ *Id.* at 11-23.

15. Although most of these principles are well integrated into the Israeli legal system, the potential additional impact of Fair and Equitable Treatment on the domestic government can be significant and should not be ignored¹⁴.
16. The “Full Protection and Security” obligation, which is tied to the Fair and Equitable Treatment, provides the guarantee of full protection by granting police protection against physical interferences by private actors. Although these cases tend to be less common in recent times, early investment arbitration claims raised this obligation in the context of destruction of real estate by local armed forces¹⁵. Yet, international investment law jurisprudence has interpreted this obligation as a commitment to provide “legal security” as well¹⁶. Thus, a breach of investors’ legal rights by increasing royalty rates and/or taxes applicable to existing holders of Petroleum Rights in Israel can violate the “Full Protection and Security” obligation.
17. The US-Israel FCN Treaty also includes the parties’ commitment not to expropriate without compensation. Article VI(3) of the US-Israel FCN Treaty states: “Property of nationals and companies of either Party shall not be taken except for public purposes, nor shall it be taken *without the payment of just compensation*. Such compensation shall be in an *effectively realizable form* and shall represent *the equivalent of the property taken*; and *adequate* provision shall have been made at or prior to the time of taking for the determination and *prompt payment thereof*.”
18. This Article reflects the Hull Formula in customary international law. According to this rule, international law requires “*prompt, adequate and effective*” compensation for the expropriation of foreign investments¹⁷. United States Secretary of State Cordell Hull introduced this formula in response to Mexico’s nationalization of American petroleum companies in 1936 and then a number of developed countries endorsed it on the international stage. Despite some disagreements over the years, it is still the investment protection standard in case of expropriation as codified in many investment treaties.
19. Historically, early investor-state arbitration cases dealt with direct expropriation, where host states had deprived foreign investors of the legal rights of ownership to their property¹⁸. The tribunals faced the question what rights to property can be

¹⁴ Similar argument was raised by Stephan Schill in the context of the Chinese legal system. See Stephan Schill, *Tearing Down the Great Wall: the New Generation Investment treaties of the People’s Republic of China*, 15 *Cardozo J. Int’l & Comp. L.* 73, 103-106.

¹⁵ See, e.g., *American Manufacturing and Trading Inc. v. Republic of Zaire* (ICSID Case No. ARB/93/1), Award, February 21, 1997, 5 ICSID Reports 11.

¹⁶ For a discussion on the development of the Full Protection and Security principle in modern international investment law see Christoph Schreuer, *Full Protection and Security*, *J Int. Disp. Settlement* (2010), 1(2), 353-369.

¹⁷ See Andreas F. Lowenfeld, *International Economic Law* (Oxford University Press, 2002), 395.

¹⁸ An example of a rare direct expropriation case in recent years is the *Middle East Cement Shipping and Handling* case, where the Ministry of Construction in Egypt issued a decree that effectively revoked the

- the object of compensable taking and what should be the standard of compensation for the deprived investment as the parties already agreed that a direct taking had occurred¹⁹.
20. Modern cases, on the other hand, focus on indirect expropriations in the regulatory context and offer a thorough discussion on whether the economic impact of a regulatory action on the investment is considered ‘taking’ and whether this taking is a violation of the expropriation standard in applicable bilateral or multilateral treaties or customary international law²⁰. Among these actions I can mention a municipal authority’s permit requirement²¹, termination of a tax rebate regime,²² and a new regulation prohibiting the export of hazardous materials to a neighboring country²³.
 21. The US-Israel FCN Treaty refers to ‘taking’ in general and does not differentiate between direct and indirect expropriation. In fact, subsequent Israeli investment treaties do not make such distinction and prefer to use the general term ‘*measures having effect equivalent to nationalization or expropriation*’. Such negative effects can impact the substance or value of the property or void the investor’s control of it.
 22. The US-Israel FCN Treaty and subsequent Israeli treaties lack explanatory notes and do not provide any content or guidelines to the terms ‘taking’ and ‘expropriation’. They therefore leave it to investment arbitrators to analyze each investment according to the ‘expropriation’ jurisprudence in international investment arbitration. This jurisprudence is complex and inconsistent, and could potentially create a situation of conflicting decisions among investment arbitral tribunals, especially in the indirect expropriation context.²⁴ While investor-state arbitral tribunals are looking for a comprehensive and consistent jurisprudence, most decisions are facts-specific and made on a case-by-case basis, balancing the right to regulate with indirect expropriation.
 23. Several other investment treaty models²⁵ offer more concrete guidelines that can be used when interpreting the US-Israel FCN Treaty or an Israeli investment treaty, since many provisions in investment treaties are gradually meeting the

rights under a license for importation and storage of bulk cement at a Suez port. See *Middle East Cement Shipping and Handling Co. v. Arab Republic of Egypt* (ICSID case no. ARB/99/6), Award, April 12, 2002, 173.

¹⁹ J. Paulsson and Z. Douglas, *Indirect Expropriation in Investment Treaty Arbitrations*, in *Arbitrating Foreign Investment Disputes : Procedural and Substantive Legal Aspects*, 151 (N. Horn and S. Kröll eds., The Hague [etc.]: Kluwer Law International, 2004).

²⁰ *Id.*

²¹ *Metalclad Corporation v. The United States of Mexico* (ICSID case no. ARB(AF)/97/1), Award, August 30, 2000, 40 ILM 36 (2001).

²² *Marvin Feldman v. Mexico* (ICSID case no. ARB(AF)/99/1), Award on Merits, December 16, 2002.

²³ *Myers Inc. v. Government of Canada*, Interim Award, June 26, 2000.

²⁴ See *International Investor Protection: Indirect Expropriation Claims under NAFTA Chapter 11* (CRS report for Congress).

²⁵ Most countries have a BIT program based on a pre-drafted investment agreement model.

legal requirements for being part of customary international law²⁶. The U.S. 2004 Model BIT, for instance, includes explanatory notes that differentiate between direct and indirect expropriation²⁷, although both are covered as long as they interfere “with tangible or intangible property right or interest in an investment”²⁸. According to these notes, direct expropriation is made through a formal transfer of title or outright seizure²⁹, while indirect expropriation is an action or a series of actions with an equivalent effect but without a formal transfer of title or outright seizure³⁰.

24. An indirect expropriation, per these guidelines, will be examined on a case-by-case basis. Some of the factors that should be taken into account are³¹: (i) the economic impact of a government action (not on a standalone basis); (ii) the extent to which a government action interferes with distinct, reasonable investment-backed expectations; and (iii) the character of the government action. This formula provides a broad range of relevant factors and avoids a previously proposed and highly criticized³² general ‘test’ for indirect expropriation, which tries to take into account multiple decisions of international tribunals and is impractical in a particular set of circumstances.
25. A careful review of recent international investment arbitration cases strongly emphasizes investors’ frustration when their legitimate expectations, based on a reasonable reliance upon representations and undertakings by the host state³³, are not met. Regarding the element of the economic impact on the investment, it cannot be a conclusive factor in an indirect expropriation decision but will support a decision regarding a regulatory taking, which is the first phase before an unlawful expropriation is considered³⁴, or will establish an expropriation in extreme circumstance, where the entire investment value has been destroyed, even if the regulatory action is in public interest, in order for an individual not to carry the burden for the community³⁵.

²⁶ Efraim Chalamish, *The Future of Bilateral Investment Treaties*, 34 (2) Brooklyn Journal of International Law 303 (2009), supported Lowenfeld’s view on this issue. See Lowenfeld, *supra* note 17, at 397-403.

²⁷ Annex B to U.S. 2004 Model BIT, available at <http://www.state.gov/documents/organization/117601.pdf> (last visited September 30, 2010)

²⁸ *Id.*, Section 2.

²⁹ *Id.*, Section 3.

³⁰ *Id.*, Section 4.

³¹ *Id.*, Section 4(a).

³² J. Paulsson and Z. Douglas, for instance, criticized the general test approach in their article *Indirect Expropriation in Investment Treaty Arbitrations*, *supra* note 19.

³³ In the case of *Pope & Talbot Inc. v. The Government of Canada*, for example, where the Canadian government reduced the investor’s allocation of a fee free quota for the export of softwood lumber to the U.S., the tribunal did not find any indirect expropriation since the reliance and governmental undertaking elements were missing. See *Pope & Talbot Inc. v. Government of Canada*, Award, 7 ICSID Reports 43.

³⁴ On the ambiguity between taking and unlawful expropriation and its consequences see Paulsson and Douglas, *Indirect Expropriation in Investment Treaty Arbitrations*, pp. 148-150.

³⁵ *Id.* at 158.

Taxation and Indirect Expropriation

26. Since taxation is not a direct expropriation due to the nature of taxation, the indirect effect of regulatory instruments is more relevant to our discussion. The few investor-state arbitration cases that discuss tax measures examine the legality of these measures and their ‘expropriation without compensation’ effect. International tribunals do deem tax measures arbitrable but struggle to discuss expropriation in the taxation context since “taxation by its nature constitutes an involuntary seizure of property that resembles expropriation in even the best circumstances”³⁶.
27. A critical point in many international investment cases involving taxation is the procedural barrier of specific provisions in the applicable treaty that exclude arbitration of certain tax measures or collection measures. Thus, for example, NAFTA Article 2103(4) applies nondiscrimination obligations to taxes “other than those on income or capital gains.” Such tax exceptions in investment treaties are driven by administrative convenience or national tax policies and many state parties prefer not to arbitrate them in international tribunals. The US-Israel FCN Treaty does not include specific provisions that exclude arbitration of tax measures with respect to nondiscrimination and expropriation obligations, a fact that supports the arbitrability of the Israel’s royalty and tax measures in the oil and gas industry.
28. Both *Occidental* and *Encana* recent decisions³⁷, which deal with the failure to provide foreign investors VAT tax refund by the Ecuadorian government based on agreements between oil companies and the government, concluded that a failure to give a tax rebate does not constitute expropriation. Despite the different tax context, these decisions provide some guidelines regarding how to differentiate between normal taxes and abusive taxes which are considered expropriation.
29. According to *Encana*, foreign investors cannot assume ‘tax freeze’ regime. As we all know, states regularly do change their tax rules. The tribunal presumes that “In the absence of a specific commitment from the host State, *the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment.*”³⁸
30. The *Encana* tribunal continues and concludes that taxation would be considered an expropriation in exceptional cases:

³⁶ William W. Park, Arbitrability and Tax in Arbitrability: International and Comparative Perspectives, L. Mistelis & S. Brekoulakis (eds.), 179, 184.

³⁷ *Occidental Exploration and Production Co. v. Republic of Ecuador*, Award (LCIA Case No. UN3467, UNCITRAL), July 1, 2004, [2005] 2 Lloyd’s Rep 240; *EnCana Corporation v. Republic of Ecuador*, Award (LCIA Case No. UN3481, UNCITRAL), February 3, 2006.

³⁸ *Elcana*, para. 173.

- “Of its nature all taxation reduces the economic benefits an enterprise would otherwise derive from the investment. *It will only be in an extreme case that a tax which is general in its incidence could be judged as equivalent in its effect to an expropriation of the enterprise which is taxed.*³⁹”
31. What kind of tax would be considered expropriation? The tribunal continues:
“Only if a tax law is *extraordinary, punitive in amount or arbitrary* in its incidence would issues of indirect expropriation be raised.” In the *Encana* case, the denial of VAT refunds in the amount of 10% of transactions associated with oil production and export was not considered expropriation by the tribunal since Elcana could continue to explore and sell oil and the tax measure did not deny the foreign investor “in whole or significant part” the benefits of its investment⁴⁰. Similarly, the *Link-Trade* tribunal did not find expropriation following the elimination of exemption from duties and taxes on imports⁴¹. An increase of royalty rate from 12.5% to 40%, for example, which is within the common range in global markets, may not be considered “*extraordinary, punitive in amount or arbitrary*” by future tribunals.
32. Clearly, any stabilization clause in an investment contract between Israel and its gas and oil investors would have created a legal right not to change the tax rules, but any violation of this right would not necessarily violate other international investment protection standards discussed above.
33. While Fair and Equitable Treatment, Full Protection and Security, and Expropriation with compensation are absolute standards, US-Israel FCN Treaty also includes contingent standards, the National Treatment and Most-Favored-Nation (“MFN”) obligations. Several provisions in this treaty require the Israeli government to give foreign investors the same treatment it gives its own nationals and the best treatment it gives nationals of a third state with which the Israeli government signed another investment treaty.
34. The majority of international investment law cases conclude that, according to the National Treatment standard, foreign investors should get a treatment equivalent to the best treatment accorded to the local comparable without a need to show disproportionate disadvantage to the foreign investor⁴². Modern Israeli treaties include the same expression ‘no less favorable’, which should be interpreted in the same way. Investor-state arbitral tribunals have discussed this standard and evaluated the treatment by comparing the foreign investor and the most directly

³⁹ *Elcana*, para. 173.

⁴⁰ *Elcana*, para. 174.

⁴¹ *Link-Trade v. Moldova*, Final Award, UNCITRAL Arbitration Rules (2002), available at <http://ita.law.uvic.ca/documents/Link-Trading-Moldova.pdf>.

⁴² See, e.g., *Pope & Talbot Inc. v. Government of Canada*, Award, 7 ICSID Reports 43 (NAFTA/UNCITRAL, 2002, Dervaird P, Greenberg & Belman) 118. The tribunal assessed the discriminatory softwood lumber regime and found a breach of Article 1102 of NAFTA, which is the national treatment provision.

comparable local investor or investors in the same business or economic sector⁴³, even when only one investor is in the same business sector, such as the *Feldman* case⁴⁴.

35. The proposed new gas and oil regulatory regime in Israel, according to statements made by Israeli government officials, would not discriminate between foreign investors and local Israeli companies⁴⁵. The proposed rules would target the oil and gas industry as a whole. If this is the case, a comparison between the U.S. investors and the most directly comparable local investors would show no discrimination.
36. The MFN treatment, like the National Treatment standard, has been subject to discussions at the International Law Commission⁴⁶ and to an extensive review by international arbitral tribunals. This standard allows foreign investors in host state to import more-favored provisions from treaties between the host state and other third countries. Thus, American investors in Israel can base their claims on the most favored standards provided by Israel in treaties with other countries. One possible result could be the implementation of indirect expropriation provision from modern Israeli investment treaties while this provision is not explicitly included in the US-Israel FCN Treaty or the application of protection standards to subsidiaries in third states.

The Legal Procedures Available to Foreign Investors

37. Friendship, Commerce, and Navigation treaties and modern international investment agreements include a specific section which lists the various dispute settlement forums the parties to the treaty had agreed to in order to exercise their legal rights. These agreements can include a state-state dispute settlement mechanism, an investor-state international arbitration mechanism, or both. The goal of any such mechanism is to provide an effective legal forum to bring a claim by the foreign investor or by the home state.
38. Among the common forums for settling international investment disputes between foreign investors and host states we can mention the International Center for Settlement of Investment Disputes (“ICSID”), International Chamber of Commerce (“ICC”), London International Court of Arbitration (“LICA”), or the International Court of Justice (“ICJ”).
39. The vast majority of modern investment treaties, the successors of the FCN treaties, include a separate section which provides a dispute settlement

⁴³ For a different approach which rejects the comparison with the applicable sector exclusively see *Occidental Exploration and Production Co. v. Republic of Ecuador*, *supra* note 37.

⁴⁴ See *Feldman v. United Mexican States*, Award (NAFTA/ICSID) (AF) , December 16, 2002, 7 ICSID Reports 318, 388-397.

⁴⁵ See, e.g., <http://www.globes.co.il/news/article.aspx?did=1000565443> (last visited September 22, 2010) .

⁴⁶ See, e.g., International Law Commission, *Draft Articles on Most-Favored-Nation Clauses*, [1978] 2(2) YB ILC 16, Articles 4, 7.

mechanism between the foreign investor and the host state in addition to the state-state dispute settlement mechanism. This important innovation of international investment law enforces the obligations of the parties to the treaty and grants a *binding* legal procedure *without a direct privity* between the investor and the host state⁴⁷. The ability of a foreign investor to bring a direct claim against a host state in an international investor-state arbitral tribunal is one of the important developments in the international investment law regime since the 1960s.

40. Historically, foreign investors could only enjoy diplomatic protection, while the perception was that their claims belong to their home government. Modern BITs, based on the old Friendship, Commerce and Navigation treaties, include a new mechanism that allows foreign investors to bring direct claims against foreign governments based on a prior consent given by the respective states. The host state provides its consent in advance by signing a bilateral investment treaty with the home state of the foreign investor. The investor provides her consent by sending a claim to an international investor-state arbitral tribunal.
41. While many developing countries rejected the concept of binding investor-state dispute settlement mechanism in the 1980s and even in the 1990s, Israel integrated this concept into its investment treaties since the inception of the BITs program in the early 1980s. By the time Israel negotiated and signed its first BIT with a developing country, Zaire, in 1985, Israel already signed the ICSID Convention⁴⁸, a significant step towards a legal integration into the global economy. Moreover, as Israel shifted from a capital-importing economy to a capital-exporting economy, its international economic legal environment had to be adjusted accordingly and protect Israel's foreign economic interests abroad.
42. Consequently, Article 8 of the New Israeli Model, based on which Israel signed its investment agreements since 2004, provides for several dispute resolution alternatives if negotiations between the parties are not fruitful within 6 months⁴⁹. The investment treaty serves as an unconditional consent of the host country to the submission of a dispute to international arbitration, while the foreign investors provide their consent by initiation of arbitration procedure. This consent is necessary to apply the Additional Facility Rules of ICSID when applicable, and to enforce the arbitration award⁵⁰.

⁴⁷ For a description of the development of this binding legal mechanism in international investment law see Jeswald Salacuse, *Is There a Better Way? Alternative Methods of Treaty-Based Investor-State Dispute Resolution*, 31 *Fordham Int'l L.J.* 138, 140-153.

⁴⁸ Israel signed the Convention on June 16, 1980, and it entered into force on July 22, 1983.

⁴⁹ The New Israeli Model, Article 8, Section 2. An investor in the New Model can choose from the following options: (a) a local court of host country; (b) conciliation; (c) an ICSID arbitration, provided that both contracting parties are parties to the ICSID Convention; (d) arbitration under the Additional Facility Rules of ICSID in case only one of the parties is a party to the ICSID Convention; or (e) an ad hoc arbitration under the Arbitration Rules of UNCITRAL.

⁵⁰ The New Israeli Model, Article 8, Section 3.

Dispute Settlement and Procedural Rights

43. The parties to the US-Israel FCN Treaty agreed to settle foreign investment disputes at the International Court of Justice at The Hague, Netherlands. Article XXIV of the US-Israel FCN Treaty reads as follows:

“Any dispute between the Parties as to the interpretation or application of the present Treaty, not satisfactorily adjusted by diplomacy, *shall be submitted to the International Court of Justice*, unless the Parties agree to settlement by some other pacific means.⁵¹”

This agreed-upon dispute settlement mechanism, which includes a state-state procedure only, reflects the common practice in that period and the intent of the United States and Israel as the parties to the FCN Treaty to legally settle any disputes between them at the ICJ exclusively.

44. Foreign investors can decide to avoid the state-state mechanism of Article XXIV of the US-Israel FCN Treaty above-mentioned and initiate a direct claim against the Israeli Government in ICSID (Washington DC) based on potential violations of its commitments in the US-Israel FCN Treaty and customary international law, as discussed in the second section of this Opinion. The legal basis for such jurisdiction could be the fact that the US-Israel FCN Treaty includes an MFN provision, which allows foreign investor to import more-favored procedural rights from other bilateral treaties. The MFN standard allows foreign investors in the host state to use specific BITs provisions between the host state and third parties, which will eventually provide the investors with the same treatment accorded to the third-party foreign investors⁵². In other words, since at a later stage Israel signed BITs that include an investor-state ICSID mechanism, the parties to an earlier treaty, such as the US-Israel FCN Treaty, can argue that they should enjoy the better protection standards given to nationals of other third party states. According to this argument, you cannot provide a foreign investor with protection of substantive rights without protecting procedural rights, which frequently pave the way to exercising protection of substantive rights. The inapplicability of the MFN, a contingent protection standard, to procedural rights can be a substantial barrier for any potential claim of foreign investors against Israel in ICSID based on the US-Israel FCN Treaty.

45. A significant part of the MFN jurisprudence is tied to the substantive discussion about the scope of the MFN principle. Unlike the National Treatment principle, MFN requires a careful review of treaties between third parties, including certain provisions which have been negotiated by these parties, and therefore the

⁵¹ US-Israel FCN Treaty, Article XXIV, paragraph 2.

⁵² Thus, for example, MTD, a Malaysian investor, used the Croatian and Danish BITs with Chile to enforce the observance of foreign investment contracts and the obligation to grant the necessary permits. *See MTD Equity Sdn Bhd & Anor v. Republic of Chile*, Award (ICSID Case No. ARB/01/7), May 25, 2004, 44 ILM 91 (ICSID, 2004).

applicability of these provisions to other parties through the MFN clause calls for a diligent consideration⁵³. Moreover, it is not clear whether arbitral tribunals can apply the MFN clause to the procedural rights of the BIT, and more specifically to the dispute settlement provisions, due to their bilateral nature, inability to compare treaties and evaluate preferential treatment with respect to legal procedures, and the potential chaos that could be created by applying multiple dispute settlement provisions of several investment treaties in one setting. Yet, since the dispute settlement mechanism makes the BIT's substantive rights enforceable, the correlation between the substantive and procedural rights potentially builds the case for application of the MFN principle to procedural rights.

46. A careful review of investment arbitration jurisprudence reveals conflicting conclusions on the question of the application of the MFN standard to procedural rights. The leading *Maffezini* case, which was based on the Argentina-Spain BIT,⁵⁴ allowed using the MFN clause to apply the dispute settlement provisions of the Chile-Spain BIT⁵⁵ that do not require recourse to local courts before bringing an ICSID claim and has therefore provided for a shorter waiting period before applying international investment arbitration⁵⁶. Although this decision was heavily criticized by several legal scholars, it has been followed by other arbitration cases, such as *Siemens v. Argentina*⁵⁷ *Tecmed v. Mexico*⁵⁸ and *Suez v. Argentina*⁵⁹. The leading argument behind these decisions was that the procedural provisions in investment treaties are inherently connected to the substantive provisions and have an impact on the use of these rights.

47. However, several investment arbitration decisions and draft treaties have disagreed with that approach. For instance, the Dominican Republic-Central America Free Trade Agreement (or CAFTA) explicitly excludes dispute settlement provisions from being covered by the MFN provision⁶⁰. The *Salini v.*

⁵³ Campbell McLachlan, Laurence Shore, Matthew Weiniger, *International Investment Arbitration: Substantive Principles*, 254 (Oxford, 2007).

⁵⁴ Agreement on the Promotion and Reciprocal Protection of Investments between the Kingdom of Spain and the Argentine Republic, signed in Buenos Aires on October 3, 1991 and entered into force on September 28, 1992; 1699 UNTS 202.

⁵⁵ Agreement on the Reciprocal Protection and Promotion of Investments between the Kingdom of Spain and the Republic of Chile, signed in Santiago on October 2, 1991 and entered into force on March 28, 1994; 1774 UNTS 15.

⁵⁶ *Emilio Agustin Maffezini v. Kingdom of Spain*, Jurisdiction (ICSID Case No. ARB/97/7), January 25, 2000, 5 ICSID Reports 387, 404-411.

⁵⁷ *Siemens AG v. Argentine Republic* (ICSID Case No. ARB/02/8), Jurisdiction, August 3, 2004.

⁵⁸ *Tecnicas Medioambientales Tecmed SA v. United Mexican States*, Award (ICSID Case No. ARB (AF)/00/2), May 22, 2003, (2004) 43 ILM 133.

⁵⁹ *Suez, Sociedad General de Aguas de Barcelona SA & anor v. Argentine Republic*, Jurisdiction (ICSID Case No. ARB/03/17), May 16, 2006.

⁶⁰ The draft includes a footnote which was deleted in the final text of the treaty to reflect that the MFN and National Treatment provisions do not apply to dispute resolution mechanisms. The second footnote states that “the parties agree that the following footnote is to be included in the negotiation history as a reflection of the Parties’ shared understanding regarding the interpretation of the most-favored-nation and national treatment obligations.”

*Jordan*⁶¹ and *Plama v. Bulgaria*⁶² decisions have also rejected *Maffezini*'s rationale. As a matter of fact, the *Plama* tribunal concluded that any application of the MFN provision to dispute settlement provisions can undermine the harmonization process of dispute settlement provisions, and that the public policy exceptions of *Maffezini* do not actually support the rationale behind the rule as interpreted by the *Maffezini* tribunal. As a result, it concluded, the MFN provision should not be applied to dispute settlement provisions unless the parties have explicitly agreed to do so in advance⁶³. To sum, the jury is still out and there is significant judicial uncertainty with respect to the application of an MFN clause to procedural rights.

48. The remaining question in this context is what will be the decisive factors with respect to a tribunal's decision whether to accept or not an investment claim against the State of Israel in ICSID. The *Maffezini* decision provides us with some public policy guidelines and explains in which circumstances the tribunal should not apply the MFN standard to procedural rights to establish jurisprudence. According to one of the policy considerations, tribunals should not use the MFN principle to shift the dispute to a *different forum* against one of the parties' will. The rationale is clear. It is hard to qualitatively assess the differences between the various legal forums and it is important to respect the consent of the parties in that respect. The tribunal notes:

“Third, if the agreement provides for a particular arbitration forum, such as ICSID, for example, *this option cannot be changed by invoking the clause, in order to refer the dispute to a different system of arbitration...* It is clear, in any event, that a distinction has to be made between the legitimate extension of rights and benefits by means of the operation of the clause, on the one hand, and disruptive treaty-shopping that would play havoc with the policy objectives of underlying specific treaty provisions, on the other hand.”⁶⁴

49. The *Plama* decision followed this policy consideration and refused to allow the use of the MFN clause to introduce a completely new dispute settlement procedure (in this case ICSID arbitration) instead of an international ad hoc arbitration court under UNCITRAL rules against the will of the parties⁶⁵.

50. In the very recent case of *Tza Yap Shum v. Republic of Peru*⁶⁶ an investor-state arbitral tribunal struggled with the question whether the tribunal has jurisdiction over a fair and equitable treatment investment claim while the applicable treaty, China-Peru BIT, includes a very limited jurisdictional provision. The foreign

⁶¹ *Salini Construttori SpA & Italstrade SpA v. Hashemite Kingdom of Jordan*, Jurisdiction (ICSID Case No. ARB/02/13), November 9, 2004.

⁶² *Plama Consortium Ltd. v. Republic of Bulgaria*, Jurisdiction (ICSID Case No. ARB/03/24), February 8, 2005, 20 ICSID Rev-FILJ 262.

⁶³ *Id.*, para. 223.

⁶⁴ *Emilio Agustin Maffezini v. Kingdom of Spain*, Jurisdiction, para. 63.

⁶⁵ *Plama Consortium Ltd. v. Republic of Bulgaria*, Jurisdiction, para. 183-227.

⁶⁶ *Tza Yap Shum v. Republic of Peru*, Decision on Jurisdiction (ICSID Case No. ARB/07/6), June 19, 2009.

investor in this case argued that the language of the MFN Article of the BIT is broad enough to be applied to procedural rights, including a very inclusive dispute settlement mechanism that China agreed to in other later BITs. It is important to note in this context that the Chinese government traditionally avoided comprehensive dispute settlement mechanism and limited such a system to the level of compensation only (in early treaties) or expropriation (in later treaties)⁶⁷. Despite a broad MFN language, like in the US-Israel FCN Treaty in our case, the *Tza Yap Shum* tribunal concludes that that MFN clause cannot be used by itself to establish jurisdiction and tribunal's competence if the parties themselves explicitly agreed to a different mechanism.

“The Tribunal considers that the situation in the present case is closer to that in *Plama v. Bulgaria*, wherein Claimant had argued that the MFN clause in Article 3 of the relevant BIT had to be interpreted so as to allow Claimant first to skip the two preliminary stages agreed for the settlement of disputes, to then replace the arbitral proceeding agreed upon (ad hoc arbitration under the UNCITRAL arbitration rules) with an ICSID arbitration. The Tribunal refused to allow the use of the MFN clause to introduce a completely new dispute settlement procedure instead of a "an international ad hoc arbitration court". By doing so, it may be affirmed that the tribunal in *Plama* actually took in to account the assertions contained in paragraph 63 of the award in *Maffezini*. Anyhow, following a similar reasoning, this Tribunal concludes that it may not allow interpreting the MFN clause of the BIT so as to override the more specific wording of Article 8(3). For the above reasons, the Tribunal does not accept the arguments presented by Claimant with regard to the interpretation of the MFN clause of the BIT (Article 3). The Tribunal finds that Article 3 cannot be interpreted so as to extend the jurisdiction of the Centre or to be the basis for an independent source for the competence of the Tribunal.⁶⁸”

51. United States and Israel agreed in the US-Israel FCN Treaty to refer investment dispute to the ICJ in case diplomatic efforts fail and recent investment arbitration cases lead to the conclusion that future tribunals would reject an ICSID jurisdiction and tribunal's competence against this agreement despite a broad MFN provision. Moreover, it is unclear why an ICSID tribunal would be more favorable forum to the United States than the ICJ. Thus, for example, the US-Israel FCN Treaty like many other modern BITs poses additional jurisdictional and procedural requirements that the ICJ does not require.

⁶⁷ The new generation of Chinese Investment Treaties reflects the new economic order and the rising role of China as a capital-exporter in the world economy. Thus, the new treaties include more comprehensive dispute settlement provisions. For an overview of the Chinese BITs program see Axel Berger, *China's New Bilateral Investment Treaty Programme: Substance, Rational and Implications for International Investment Law Making*, German Development Institute, Paper prepared for the American Society of International Law, International Economic Law Interest Group (ASIL IELIG) 2008 biennial conference “The Politics of International Economic Law: The Next Four Years”, Washington, D.C., November 14-15, 2008, available at <http://www.asil.org/files/ielconferencepapers/berger.pdf> (last visited September 22, 2010).

⁶⁸ *Tza Yap Shum v. Republic of Peru*, para. 220.

52. Indeed, the ICSID mechanism has not been in existence in 1951 when the FCN Treaty was signed, but the United States and Israel had the opportunity to amend the treaty or adopt a new modern BIT which will address this issue and many other emerging dilemmas that have developed since the original signature of the treaty. The abovementioned CAFTA example demonstrates the emerging nature of the investment law regime and how new treaties can respond to state practice and various decisions by investor-state arbitral tribunals.
53. It is important to note that the old and new Israeli investment treaty models ignore the question and do not refer specifically to procedural provisions in the context of the MFN standard. Historical research does not reveal any public records or judicial decisions which interpret the Israeli MFN provision. The UK, for example, chose to include a reference to dispute settlement provisions in the MFN provision⁶⁹ within its draft model.
54. The language of the applicable US-Israel FCN Treaty provision itself supports this conclusion. According to Article 31 of the Vienna Convention, “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”⁷⁰ Since the United States and Israel agreed that unsettled disputes “shall be submitted to the International Court of Justice, *unless the Parties agree to settlement by some other pacific means.*” we can conclude that the parties to the treaty kept the pacific option open while referring to the ICJ all legal disputes.

ICJ and Local Courts

55. While this Opinion concludes that the United States will not be able to bring an ICSID direct claim against Israel, the holders of Petroleum Rights can still submit their claims to local Israeli courts. The implementation of international investment law by Israeli courts in any future disputes is not within the scope of the Opinion.
56. Since any investor-state investment dispute according to the US-Israel FCN Treaty can be submitted to the ICJ, the U.S. Government will have to decide whether to exercise its right to bring a claim against the Israeli government based on alleged violation of the US-Israel FCN Treaty and customary international law. Since the ICJ is a forum for state-state disputes only, American investors in Israel will not be able to bring a direct claim against Israel in this institution.
57. It is important to discuss in this context what is the American approach towards settling disputes at the ICJ. The United States has been reluctant to use the ICJ as a forum to settle international economic disputes. In fact, there were very few investment disputes being litigated in the ICJ’s history⁷¹. Moreover, a review of

⁶⁹ UK Model BIT, Article 3 (3).

⁷⁰ Vienna Convention on the Law of Treaties, 1969.

⁷¹ The last known case is *Oil Platforms (Islamic Republic of Iran v. United States of America)*, Judgment, I.C.J. Reports 2003, p. 161.

recent U.S. investment treaties shows that the U.S. Government has not included the ICJ among the available legal forums to settle state-state investment disputes.

58. United States has perceived the ICJ in recent years as the voice of the developing world, expanding its jurisdiction to criticize its actions in world stage. Prof. Sean Murphy, who advised the U.S. government in some of its ICJ cases, explains “One gets the impression that the Court —fifty years after its creation— is tired of some of the formal constraints that applied earlier in its life and —looking around at the robustness of dispute resolution in other international fora— is ready to expand the reach of its power.”⁷²,
59. Prof. Murphy brings several examples to support his argument. As Israel itself has experienced, although only states may appear before the ICJ, the court found that a non-state entity like Palestine may do so if a dispute has the form of an advisory opinion. Similarly, as we learned from the *Oil Platforms* case⁷³, the ICJ is willing to review the legality of the use of military force by the United States based on a treaty that the ICJ has found was not violated. Prof. Murphy concludes that “if the United States saw concrete benefits in being more closely associated with the Court, it might look for ways to improve relationships, but for the world’s premier superpower the benefits appear slim while the costs appear quite high. Consequently, the United States may take steps to further remove itself from the reach of the ICJ’s jurisdiction, through terminating some or all of the outstanding treaties that provide for the Court’s jurisdiction.”⁷⁴ To sum, this position, which is clearly subject to internal discussion within the U.S. government, may lead to amendment of the US-Israel FCN Treaty that refers to ICJ jurisdiction and to reluctance to initiate claims at this institution.
60. Finally, Israel and United States did not sign the Energy Charter Treaty (“ECT”)⁷⁵, which is the leading treaty in the post-Soviet era dedicated to market access in the oil and gas industry and investment protection and arbitration in this area⁷⁶. United States did participate in the negotiations on the ECT in the early 1990s but has not signed it yet. Its current status is observer⁷⁷.

Conclusion

61. American investors in Israel enjoy absolute investment protection standards according to customary international law and the US-Israel FCN Treaty. This is a reflection of Israel’s economic and legal status in global markets as a safe and stable environment for foreign investors. These standards of protection include

⁷² Sean Murphy, *The United States and the International Court of Justice: Coping with Antinomies*, in *The United States and International Courts and Tribunals* (Cesare Romano, ed., 2008), p.57.

⁷³ *Oil Platforms* (Islamic Republic of Iran v. United States of America), Judgment, I.C.J. Reports 2003, p. 161.

⁷⁴ Sean Murphy, *The United States and the International Court of Justice: Coping with Antinomies*, p.58.

⁷⁵ Energy Charter Treaty, December 17, 1994, 34 I.L.M. 360.

⁷⁶ See generally *Investment Arbitration and the Energy Charter Treaty* (Clarisse Ribeiro ed., 2006).

⁷⁷ <http://www.encharter.org/index.php?id=61&L=0> (last visited September 27, 2010).

Fair and Equitable Treatment, Full Protection and Security, and the obligation not to expropriate without compensation, among other protection provisions. This Opinion shows that increases of royalty rate or tax rate in the oil and gas industry would unlikely be considered an indirect expropriation since international investment law jurisprudence regards taxes as expropriation only in extreme cases. Yet, these taxation measures would likely be considered a violation of the Fair and Equitable Treatment and the Full Protection and Security principles as they do not meet the legitimate expectations of the existing holders of the Petroleum Rights. Their investments in the risky and cash-intensive oil and gas industry in Israel could be based on a reasonable reliance upon representations and undertakings by the Israeli governments, which should be explored further as part of any future legal dispute.

62. According to the US-Israel FCN Treaty, United States can initiate a claim against Israel at the International Court of Justice based on Israel's violation of its international obligations to its American foreign investors. The United States has recently been reluctant to initiate such a claim in other similar circumstances. The existing holders of Petroleum Rights may try and initiate a direct claim against Israel at ICSID in Washington DC. This Opinion concludes that several procedural obstacles, such as the inability to use more-favored provisions from other treaties to pursue a procedure in a different forum, will prevent them from doing so.

Yours,

Dr. Efraim Chalamish, Esq.