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MOST-FAVOURED-NATION CLAUSE

Report of the Working Group

I. INTRODUCTION

1. At its 2929th meeting on 1 June 2007, the International Law Commission established an open-ended Working Group, chaired by Mr. Donald M. McRae, to examine the possibility of the inclusion of the topic "Most-favoured-nation clause" in its long-term programme of work.

2. The Working Group held two meetings on 16 and 17 July 2007.

3. The Working Group had before it a discussion paper prepared by Mr. McRae and Mr. Rohan Perera.[1]

II. RECOMMENDATIONS OF THE WORKING GROUP

4. The Working Group concluded that the Commission could play a useful role in providing clarification on the meaning and effect of the most-favoured-nation clause in the field of investment agreements. Such work was seen as building on the past work of the Commission on the most-favoured-nation clause.

[1] Annexed to the present report.

5. The Working Group therefore recommends that the topic of the most-favoured-nation clause be included in the long-term programme of work of the Commission.

6. The Working Group considered that an appropriate way to proceed with this topic was to establish a working group to advance the topic as follows:

- To review comprehensively State practice and jurisprudence on the most-favoured-nation clause since the conclusion of the Commission's work on this subject in 1978;

- To develop a full articulation of the issues arising out of the inclusion of most-favoured-nation clauses in investment agreements;

- To establish a dialogue with other bodies concerned with the issue of most-favoured-nation clauses, including OECD, UNCTAD and the WTO;

- To prepare commentaries on model most-favoured-nation clauses including those developed from the consideration of State practice and jurisprudence in this area.

Annex

THE MOST-FAVOURED-NATION CLAUSE

1. In 1978, the Commission adopted draft articles on the topic of the Most-Favoured-Nation (MFN) clause. No action was taken on them by the General Assembly. In 2006, at the fifty-eighth session of the ILC, the long-term Working Group discussed whether the MFN clause should be considered again and to include the topic on its long-term programme of work but the Commission did not make any decision on the matter. The Commission then invited the views of governments. At the sixty-first session of the Sixth Committee, one State supported the idea but two States expressed doubts about the wisdom of taking on the topic. The Commission has now established a working group to consider whether or not the topic of the MFN clause should be included in its long-term programme of work.

2. This discussion paper reviews the MFN clause issue; what was decided in 1978, why it was not taken any further, what has changed since 1978, and whether there is something that the Commission could usefully do on this subject.

1. The Nature, Origins and Development of MFN clauses

3. An MFN clause is a provision in a treaty under which a State agrees to accord to the other contracting partner treatment that is no less favourable than that which it accords to other or third States. It was an early and particular form of a non-discrimination clause and its origins date back to early treaties of friendship, commerce and navigation ("FCN treaties"). For example, a 1654 treaty between Great Britain and Sweden[1] provided:

> The people, subjects and inhabitants of both confederates shall have, and enjoy in each other's kingdoms, countries, lands, and dominions, as large and ample privileges, relations, liberties and immunities, as any other foreigner at present doth and hereafter shall enjoy.

[1] *Treaty of Peace and Commerce between Great Britain and Sweden*, 11 April 1654, BSP 1/691.

Such a clause guaranteed only treatment that was as good as other foreigners were to receive. It was not a guarantee of national treatment. Nationals might receive better or worse treatment than foreigners. Thus, an MFN clause was not a comprehensive non-discrimination provision.

4. As the Great Britain/Sweden agreement shows, the grant of MFN treatment was for the benefit of the "people, subjects and inhabitants" of both States. This was typical of FCN treaties. They were primarily, although not exclusively, about economic activities. The benefits being granted under these agreements were designed to facilitate the economic activities of the subjects of each State within the territory of the other State. Indeed, the rationale for granting MFN treatment was economic - the desire by the recipient of MFN treatment to avoid its own subjects from being economically disadvantaged by comparison with the subjects of third States. It was not based on any notion of the equality of States.

5. However, MFN treatment was not solely limited to the economic sphere. Bilateral treaties relating to diplomatic and consular relations also included MFN guarantees, both in respect of the ability to maintain diplomatic and consular premises and in respect of the privileges granted to diplomatic and consular personnel.[2] Once diplomatic and consular relations were regulated by multilateral conventions establishing rights across the board, there was no need for bilateral agreements preventing discrimination through the inclusion of an MFN clause.

6. Outside the economic sphere, MFN was a principle of non-discrimination suited to circumstances where relations between States were regulated through bilateral arrangements. Such clauses had less utility where relations were regulated under multilateral agreements and MFN could be covered by a general non-discrimination provision. However, MFN has retained its pre-eminence in the economic sphere, where multilateral agreements have included MFN provisions. This reflects the economic objective of MFN in this area, something that is not captured by a general non-discrimination provision.

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[2] See for example the Italo-Turkish Consular Convention of 9 September 1929, 129 L.N.T.S. 195, cited in "First report on the most-favoured-nation clause, by Mr. Endre Ustor, Special Rapporteur" (UN Doc. A/CN.4/213) in *Yearbook of the International Law Commission* 1969, vol. 2, (New York: UN, 1970) 166 at para. 57 (A/CN.4/SER. A/1969/Add.1).

7. In the economic field in the nineteenth and early twentieth centuries, MFN was often granted conditionally. Instead of granting MFN treatment automatically, a State would grant MFN treatment in exchange for a benefit provided by the other State. In other words, the grant of MFN treatment had to be paid for. This was known as “conditional MFN”. The granting of conditional MFN declined with greater realization that there were economic benefits to the granting State from granting MFN unconditionally and conditional MFN has little significance today.

8. Unconditional MFN became the cornerstone of the GATT regime. Under article I of GATT, MFN was to be granted at the border to the goods of other GATT Contracting Parties “immediately and unconditionally”. Together with the requirement of GATT article III to provide “national treatment” to those goods once they had entered the domestic market of a GATT Contracting Party, the MFN principle became the core of the principle of non-discrimination under GATT, and this has continued under the WTO. Indeed, under the WTO agreements MFN has been extended beyond its specific application to goods and applied to the area of services and the protection of intellectual property rights. Article II of the General Agreement on Trade in Services (GATS) provides for a very broad application of MFN in respect of “any measure covered by this Agreement”.

9. Notwithstanding the centrality of MFN treatment under GATT article I, the GATT and the WTO also provide important exceptions to MFN treatment. The principal exception is in respect of regional arrangements - customs unions and free trade areas - which grant preferences to the members of those agreements and hence are not providing MFN treatment to all GATT contracting parties. In accordance with GATT article XXIV, these benefits do not have to be extended to other GATT Contracting Parties or WTO Members.

10. The continuation of MFN under the regime of the WTO with its own dispute settlement process has meant that within the WTO trading regime there is an opportunity for the requirement of MFN treatment to be interpreted in a consistent way. However, MFN has been given a new lease of life with the inclusion of regional trade agreements and the explosion in the conclusion of bilateral investment agreements, all usually including some form of MFN requirement.

2. The prior work of the ILC on the MFN clause

11. The ILC's treatment of MFN clauses arose out of its work on the law of treaties. It had been proposed that a provision be included in the draft articles on the law of treaties excluding their application in the case of MFN clauses. The Commission decided not to do that but to look at MFN clauses as a separate topic.[3] The Special Rapporteur, Mr. Endre Ustor, and his successor Mr. Nikolai Ushakov, conducted exhaustive analyses of MFN clauses as they existed up until the mid-1970s. Their reports were based on considerable State practice in the conclusion of treaties that included MFN clauses in a variety of areas, decisions of the ICJ that touched on MFN clauses (*Anglo-Iranian* Case,[4] *Case concerning right of nationals of the United States of America in Morocco*,[5] *Ambatielos* Case[6]) the *Ambatielos Arbitration*[7] and a considerable body of decisions of national courts.

12. The approach of the Commission was to study the MFN clause and MFN treatment "as a legal institution"[8] and not simply as a matter of the law of treaties, and to look at the operation of the clause broadly and not be limited to the field of international trade. It sought to avoid trying to resolve matters of a "technical economic nature".[9]

13. The 30 draft articles produced by the Commission covered such matters as the definition of the MFN clause and MFN treatment (draft articles 4 and 5), its scope, the conventional rather than customary international law basis of MFN treatment (draft article 7), the scope of MFN

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[3] "Report of the Commission to the General Assembly on the work of its thirtieth Session" (UN Doc. A/33/10) in *Yearbook of the International Law Commission* 1978, vol. 2, part 2 (New York: UN, 1979) 8 at para. 15 (A/CN.4/SER.A/1978/Add.l (Part 2)).

[4] *Anglo-Iranian Oil Co. (United Kingdom v. Iran)* [1952] I.C.J. Rep. 93.

[5] *Case concerning rights of nationals of the United States of America in Morocco (France v. United States of America*) [1952] I.C.J. Rep. 176.

[6] *Ambatielos Case (Greece v. United Kingdom)* [1952] I.C.J. Rep. 28.

[7] *Ambatielos Arbitration* (United Kingdom-Greece), (1956), 12 U.N. R.I.A.A. at 83.

[8] *Supra* note 3 at para. 61.

[9] *Ibid.* at para. 62.

treatment (draft articles 8, 9 and 10), the effect of conditional and unconditional MFN (draft articles 11, 12 and 13), the source of the treatment to be provided under an MFN clause (draft articles 14-19), the time that rights arise under an MFN clause (draft article 20), termination or suspension of an MFN clause (draft article 21), and the relationship of the MFN clause to a generalized system of preferences (draft articles 23 and 24), and the special cases of frontier traffic and transit rights of land-locked States.

3. The reaction of the Sixth Committee to the draft articles

14. The draft articles on MFN were never taken any further by the General Assembly. The debate in the Sixth Committee[10] indicates several concerns about the draft articles but two matters were prominent. First, there were concerns that the draft articles did not exclude customs unions and free trade areas. This was a particular issue for EEC members, which did not want to see the benefits under the Treaty of Rome being extended through MFN to States that were not EEC members. They would have preferred excluding customs unions and free trade areas from the draft articles. Developing countries that were entering into regional free trade agreements voiced similar concerns.

15. Second, there were concerns over the treatment of the issue of development in the draft articles, including the treatment of generalized systems of preferences. For some, the draft articles did not treat the issue of preferences for developing countries adequately; for others the draft articles were straying into the debate over the New International Economic Order. The combination of these and other concerns meant that there was no constituency in the General Assembly for turning the draft articles into a convention. For some States, the draft articles should simply be seen as guidelines.

4. Developments since 1978

16. The circumstances that existed when the Commission dealt with the MFN clause in its reports and final draft articles of 1978 have changed significantly.

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[10] C6, 33rd Sess., UN Doc. A/C.6/33/SR.27-45 (1978). The topic was raised in the Sixth Committee from 1980 until 1983, in 1988 and 1989 and again in 1991.

First, several of the bilateral arrangements on which the Special Rapporteurs relied to demonstrate State practice in relation to MFN provisions have been superseded by multilateral arrangements. The consequence is that MFN today is more focused in the economic area.

Second, the GATT, which was a principal source for considering MFN has now been subsumed within the WTO. This has had the result of broadening the ambit of MFN to areas beyond goods, to services and to intellectual property. In addition, the WTO dispute settlement system with its appellate process has provided an opportunity for the MFN provisions in the WTO agreements to be subject to authoritative interpretation.

Third, there has been a vast increase in the negotiation of free trade agreements on a bilateral and regional basis and of bilateral investment agreements that include MFN provisions.

Fourth, resort to dispute settlement under investment agreements through the procedures of the International Centre for the Settlement of Investment Disputes (ICSID) or the UNCITRAL Arbitration Rules has resulted in the interpretation of MFN provisions in the investment context.

17. These developments all have implications for the way MFN clauses are to be viewed today and for the contemporary relevance of the draft articles produced by the Commission in 1978. There is now a substantial new body of practice to be taken into account in assessing how MFN clauses are being used and how they operate in practice. The relationship between the general MFN obligation in GATT article I and the power of States to grant preferential treatment to developing countries has been discussed specifically by the WTO Appellate Body.[11]

18. Practice relating to MFN clauses is also taking place in a context that is different from that which existed when the Commission last considered the MFN clause. The 1978 draft articles relied heavily on the Charter of Economic Rights and Duties of States when considering the relationship of the MFN clause to the question of preferential treatment for developing States.

[11] *EC-Conditions for the Granting of Tariff Preferences to Developing Countries* (2004) WTO Doc. WT/DS246/AB/R (Appellate Body Report).

The debate on preferential treatment for developing countries in the field of trade takes place now within the framework of the WTO whose membership is increasingly becoming universal, and in particular within the context of the Doha Development Round of multilateral trade negotiations.

19. In the field of investment agreements the nature and scope of MFN provisions has particularly come to the fore. The scope accorded to certain MFN provisions and the differing approaches taken by various investment tribunals has created what is perhaps the greatest challenge in respect of MFN provisions. This, too, is a body of jurisprudence that was not available to the Commission at the time of its earlier work.

20. In a global environment of economic liberalization and deeper economic integration, the MFN clause continues to be a critical factor in international economic relations among member States. The continuing relevance of the MFN clause could perhaps be viewed in the context of two phases. In the first phase, the growth of Bilateral Investment Promotion and Protection Agreements (BITs) in the 1990's underlined the continuing importance of the MFN clause which along with other provisions ensured international minimum standards of treatment for foreign investors and their investments. In the second phase, the emergence of Free Trade and Comprehensive Economic Partnership Agreements which provide for the liberalization of trade in goods and services and the treatment of investment in an integrated manner, with close cross linkages between services and investment sectors has brought to surface new issues with regard to the application of the MFN Clause.

21. The according of MFN treatment for investment even at the pre-establishment stage, is a feature in the Free Trade Agreements, which was not common in Investment Promotion and Protection Agreements in the past, where MFN treatment was limited to the post-establishment phase. The conclusion of these Free Trade Agreements and Comprehensive Economic Partnership Agreements, with substantive chapters on foreign investment, marks a new phase in the importance of the MFN clause in the contemporary economic relations among States. A review of the role of the MFN clause in the context of these new economic integration agreements merits closer study from a legal perspective.

5. The challenges of the MFN clause today

22. An exhaustive study of the practice of including MFN provisions in treaties would no doubt shed new light on the way that clause is operating and being applied by States. This may yield new insights about MFN. However, in the field of investment specific problems have arisen with the application of MFN clauses that may have implications for the application of MFN in other contexts as well.

23. The issue arose in *Maffezini v. Kingdom of Spain*.[12] The claimant, Maffezini, an Argentine national had brought a claim under the bilateral investment agreement between Argentina and Spain. Spain argued that in accordance with article X (3) of that agreement Maffezini had to submit the case to the domestic courts in Spain for a period of 18 months before bringing a claim under the provisions of the agreement. However, the Claimant pointed to the MFN provision in the Argentine-Spain investment agreement, (art. 4) which provided:

> In all matters subject to this Agreement, this treatment shall be not less favourable than that extended by each Party to the investments made in its territory by investors of a third country.

The Claimant was then able to show that under the Spain-Chile bilateral investment agreement, investors bringing a claim under that agreement did not have to first submit their claims to domestic Spanish courts. By comparison, then, the Argentine investor was being treated less favourably than Chilean investors in Spain. Thus, by virtue of the MFN clause in the Argentine-Spain agreement the Claimant said, it was entitled to the more favourable treatment that Chilean investors receive under the Spain-Chile bilateral investment agreement. As a result, it argued, its failure to commence a claim on the Spanish courts was not a barrier to bringing a claim under the Argentine-Spain investment agreement.

24. The tribunal rejected Spain's argument that the MFN clause in the Argentine-Spain bilateral investment agreement applied only to substantive and not procedural provisions, pointing out that by its very terms the MFN clause applied to "all matters subject to this

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[12] *Maffezini v. Kingdom of Spain*, 25 January 2000, ICSID Case No. ARB97/7.

Agreement". After a review of prior international jurisprudence and Spanish treaty practice, the tribunal concluded that the Claimant could use the MFN clause in the Argentine-Spain bilateral investment treaty to claim the better treatment provided in the Spain-Chile investment agreement and thereby avoid the obligation of having to submit its claim to the domestic courts of Spain.

25. Subsequent ICSID tribunals have both followed[13] and distinguished[14] the *Maffezini* decision, although it is not clear that any consistent interpretation of MFN provisions has emerged. The *Maffezini* decision opens the possibility that MFN clauses could have an extremely broad scope. An MFN clause has the potential for becoming a "super-treaty" provision, which would allow beneficiary States simply to pick and choose from amongst the benefits that third States receive from the other contracting party - what has been referred to as "treaty-shopping". The members of the tribunal in *Maffezini* saw potential problems with their decision and sought to limit its scope with a number of exceptions. But the principle on which those exceptions are based is not made clear in the decision nor is it clear whether such exceptions are exclusive.

26. The problem for States arising out of the *Maffezini* decision is whether they can determine in advance with any certainty what obligation they have in fact undertaken when they include an MFN clause in an investment agreement. Are they granting broad rights, or are the rights they are granting more circumscribed. The 1978 draft articles provide limited guidance on the question. Under draft article 9, a beneficiary State acquires under an MFN clause "only those rights which fall within the subject matter of the clause." But, determining the subject matter of the clause is the very question with which the *Maffezini* and other tribunals have been grappling.

27. There are further dimensions to the question of the scope of an MFN provision, in particular its relationship to other provisions in investment agreements, such as those relating to national treatment and "fair and equitable treatment". Some investment tribunals have taken the

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[13] *Siemens A.G. v. Argentine Republic*, 3 August 2004, ICSID Case No. ARB/02/8.

[14] See for example, *Salini Costruttori S.p.A. and Italstrade S.p.A. v. the Hashemite Kingdom of Jordan*, 9 November 2004, ICSID Case No. ARB/02/13.

view that an MFN clause justifies reference to other investment agreements to establish what constitutes "fair and equitable treatment".[15] This, too, has led to uncertainty in the scope of an MFN clause.

28. *Maffezini* has resulted in States trying to craft MFN clauses that will not have broad-ranging consequences. Distinctions between substantive and procedural provisions, the exclusion of dispute settlement from MFN, and the limitation of MFN to specified benefits have found their way into various agreements. The problem is that States cannot be certain how these new clauses will be interpreted in fact.

29. At one level the problem is simply as a matter of treaty interpretation. MFN clauses are worded differently in different agreements. Some are broad in scope and others are narrow. Some limit MFN treatment to those in "like circumstances". The function of the interpreter therefore is to define the precise scope of the clause in question. Under this approach the problem can be resolved through interpretation. But, at another level the question is more fundamental. Treaty interpretation does not take place in a vacuum. How an interpreter approaches an MFN clause will depend in part on how the interpreter views the nature of MFN clauses.

30. If MFN clauses are seen as having the objective of promoting non-discrimination and harmonization, then a treaty interpreter may consider that the very purpose of the clause is to permit and indeed encourage treaty shopping. An interpreter who sees an MFN clause as having the economic purpose of allowing competition to proceed on the basis of equality of opportunity, might be more inclined to favour a substantive/procedural distinction in the interpretation of an MFN provision. In this regard, the experience of the interpretation of the MFN clause in the WTO context and in other areas may provide guidance for the interpretation of MFN in the context of investment agreements.

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[15] *MTD Equity Sdn. Bhd. & MTD Chile S.A. v. Chile*, 25 May 2004, ICSID Case No. ARB/01/7; *Pope & Talbot, Inc. v. Canada,* Award of the NAFTA Tribunal, April 10, 2001, 122 I.L.R. 352 (2002).

6. What could the ILC usefully do?

31. It is clear that circumstances have changed significantly since the 1978 draft articles on MFN clauses. There is now a body of practice and jurisprudence that was not available at that time. There is also a problem that has emerged with the application of MFN clauses in investment agreements resulting in a need by States for clarification and perhaps progressive development of the law in this area.

32. The argument that the underlying problems that led the General Assembly not to proceed to a convention with the 1978 draft articles remain today would only be compelling if it was proposed that the Commission undertake to update and revise the 1978 draft articles. There are existing forums for dealing with the issues that caused concern with those draft articles. As far as the issue of generalized systems of preferences and the broader question of development are concerned, they are matters being dealt with in the context of the WTO and the Doha Development Round. As far as the issue of customs unions and free trade areas are concerned, they, too, are being dealt with within the framework of the WTO agreements. There is no reason for the Commission to seek to consider undertaking a codification or progressive development exercise in respect of a regime that is developing under the framework of GATT article XXIV and the decisions of WTO panels and the Appellate Body.

33. The issue today with respect to MFN clauses is different from the issues that created concerns with the 1978 draft articles. It has arisen specifically in the context of investment agreements, but it may be of broader application. The real question, given the nature of the problem that currently exists, is whether there is anything that the ILC as the United Nations organ concerned with the progressive development of international law and its codification can usefully do.

34. This is not to suggest that the issue is one that is narrow and technical properly falling within the purview of some other body. It is not. The fundamental questions about MFN clauses are matters of public international law. The central issue is how should MFN clauses be interpreted. And while this may appear to be a narrow question, in reality it is a broad question

involving both treaty interpretation and the nature and extent of obligations undertaken by States under the ambit of an MFN clause. It engages our understanding of the role and function of MFN clauses and of their relationship to the principle of non-discrimination in international law.

35. Other bodies have also been focusing on this topic. OECD has produced a study on MFN clauses,[16] as has UNCTAD.[17] Equally, the subject is being explored in the academic literature. This does not mean that the field is already fully occupied.

36. The contrary view, taken by some Governments, is that MFN clauses are varied and do not easily fit into general categories. Governments are able to craft clauses that suit their needs and thus there is no need for any general consideration of the subject. The problems that have arisen can be dealt with on a case-by-case basis and thus it is appropriate to let the jurisprudence on the interpretation of MFN clauses to develop as it has been doing. On this analysis there would be no role for the Commission on this topic.

37. Those who support work by the Commission in this area consider that what it could usefully do in this area is provide authoritative guidance on the interpretation of MFN clauses. This would require an exhaustive analysis of the development of the nature, scope and underlying rationale for MFN clauses, the existing MFN jurisprudence in the various contemporary areas in which the MFN clause operates today, the variety and uses of MFN clauses in contemporary practice, and how MFN clauses have been interpreted and how they should be interpreted.

38. The result of the Commission's work could be draft articles or draft guidelines relating to the interpretation of MFN clauses or it could be a series of developing model MFN clauses or

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[16] OECD, Directorate for Financial and Enterprise Affairs, *Most-Favoured-Nation Treatment in International Investment Law*, Working Papers on International Investment, Working Paper No. 2004/2 (2004). Online: <http://www.oecd.org/dataoecd/21/37/33773085.pdf>

[17] United Nations Conference on Trade and Development (UNCTAD). "Most-Favoured-Nation Treatment" (1999) UNCTAD Series on issues in international investment agreements. UN Doc. UNCTAD/ITE/IIT/10 (Vol. III).

categories of clauses with commentaries on their interpretation. Either outcome could provide guidance to States in their negotiation of agreements with MFN clauses and to arbitrators interpreting investment agreements.

39. The interpretation of MFN clauses is a topic that responds to the needs of States and practice is sufficiently developed to permit some progressive development and possibly codification in this area. The topic has a defined scope and could be completed within the current quinquennium.

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