Annex II

THE MOST-FAVOURED-NATION CLAUSE

(Working Group of the Commission)

1. In 1978, the Commission adopted draft articles on the topic of the most-favoured-nation clause.[1] No action was taken on them by the General Assembly. In 2006, at the fifty-eighth session of the Commission, the Working Group on the long-term programme of work discussed whether the most-favoured-nation clause should be considered again and whether to include the topic in 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.[2] 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 the topic of the most-favoured-nation clause should be included in its long-term programme of work.

2. This paper reviews the most-favoured-nation 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 most-favoured-nation clauses

3. A most-favoured-nation clause is a provision in a treaty under which a State agrees to grant 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. For example, a 1654 treaty between Great Britain and Sweden 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, relaxations, liberties, and immunities, as any other Foreigner at present doth, or hereafter shall enjoy there.[3]

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, a most-favoured-nation clause was not a comprehensive non-discrimination provision.

4. As the agreement between Great Britain and Sweden shows, the grant of most-favoured-nation treatment was for the benefit of the "people, subjects and inhabitants" of both States. This was typical of treaties of friendship, commerce and navigation. 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 most-favoured-nation treatment was economic—the desire by the recipient of most-favoured-nation 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, such most-favoured-nation treatment was not solely limited to the economic sphere. Bilateral treaties relating to diplomatic and consular relations also included most-favoured-nation 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.[4] 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 a most-favoured-nation clause.

6. Outside the economic sphere, most favoured nation 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 most favoured nation could be covered by a general non-discrimination provision. However, most favoured nation has retained its pre-eminence in the economic sphere, where multilateral agreements have included most-favoured-nation provisions. This reflects the economic objective of most favoured nation in this area, something that is not captured by a general non-discrimination provision.

7. In the economic field in the nineteenth and early twentieth centuries, most favoured nation was often granted conditionally. Instead of granting this treatment automatically, a State would grant it in exchange for a benefit provided by the other State. In other words, the grant of

[1] See *Yearbook ... 1978*, vol. II (Part Two), p. 16, para. 74.

[2] See *Yearbook ... 2006*, vol. II (Part Two), p. 186, para. 259.

[3] Treaty of Peace and Commerce between Great Britain and Sweden (Uppsala, 11 April 1654), *British and State Foreign Papers 1812–1814*, vol. I, Part I, London, Ridgway, 1841, p. 692 (art. IV).

[4] See, for example, the Italo-Turkish Consular Convention, of 9 September 1929, League of Nations, *Treaty Series*, vol. CXXIX, p. 195, cited in the first report on the most-favoured-nation clause, by Mr. Endre Ustor, Special Rapporteur, *Yearbook ... 1969*, vol. II, document A/CN.4/213, p. 166, para. 57.

most-favoured-nation treatment had to be paid for. This was known as "conditional most favoured nation". The granting of conditional most favoured nation declined with greater realization that there were economic benefits to the granting State from granting the treatment unconditionally, and conditional most favoured nation has little significance today.

8. Unconditional most favoured nation became the cornerstone of the General Agreement on Tariffs and Trade (GATT) regime. Under article I of GATT, most favoured nation 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 most-favoured-nation principle became the core of the principle of non-discrimination under GATT, and this has continued under the WTO. Indeed, under the WTO agreements, this principle 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 most favoured nation in respect of "any measure covered by this Agreement".

9. Notwithstanding the centrality of most-favoured-nation treatment under GATT article I, the GATT and the WTO also provide important exceptions to such 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 most-favoured-nation 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 most favoured nation 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 most-favoured-nation treatment to be interpreted in a consistent way. However, most favoured nation has been given a new lease on life with the inclusion of regional trade agreements and the explosion in the conclusion of bilateral investment agreements, all usually including some form of most-favoured-nation requirement.

2. The prior work of the Commission on the most-favoured-nation clause

11. The Commission's treatment of most-favoured-nation 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 such clauses. The Commission decided not to do that but to look instead at these clauses as a separate topic.[5] The Special Rapporteur, Mr. Endre Ustor, and his successor Mr. Nikolai Ushakov, conducted exhaustive analyses of most-favoured-nation clauses as they existed up until the mid-1970s. Their reports were based on considerable State practice in the conclusion of treaties that included most-favoured-nation clauses in a variety of areas, decisions of the ICJ that touched on such clauses (*Anglo-Iranian Oil Co. case,*[6] *Case concerning rights of nationals of the United States of America in Morocco,*[7] *Ambatielos case*[8]), the *Ambatielos Claim*[9] and a considerable body of decisions of national courts.

12. The approach of the Commission was to study the most-favoured-nation clause and most-favoured-nation treatment "as a legal institution"[10] 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".[11]

13. The 30 draft articles produced by the Commission[12] covered such matters as the definition of the most-favoured-nation clause and most-favoured-nation treatment (draft arts. 4 and 5), its scope, the conventional rather than customary international law basis of most-favoured-nation treatment (draft art. 7), the scope of most-favoured-nation treatment (draft arts. 8, 9 and 10), the effect of conditional and unconditional most favoured nation (draft arts. 11, 12 and 13), the source of the treatment to be provided under a most-favoured-nation clause (draft arts. 14–19), the time that rights arise under a most-favoured-nation clause (draft art. 20), termination or suspension of a most-favoured-nation clause (draft art. 21), the relationship of the most-favoured-nation clause to a generalized system of preferences (draft arts. 23 and 24), and the special cases of frontier traffic and transit rights of landlocked States.

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

14. The draft articles on most-favoured-nation were never taken any further by the General Assembly. The debate in the Sixth Committee[13] 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 members of the European Economic Community (EEC), which did not want to see the benefits under the Treaty Establishing the European Economic Community being extended through most-favoured-nation

[5] See *Yearbook ... 1978*, vol. II (Part Two), p. 8, para. 15.

[6] *Anglo–Iranian Oil Co. case (Jurisdiction), Preliminary Objection, Judgment of 22 July 1952, I.C.J. Reports 1952*, p. 93.

[7] *Case concerning rights of nationals of the United States of America in Morocco, Judgment of 27 August 1952*, *I.C.J. Reports 1952*, p. 176.

[8] *Ambatielos case (Greece* v. *United Kingdom), Jurisdiction, Judgment of 1 July 1952*, *ibid.*, p. 28.

[9] *Ambatielos Claim (Greece, United Kingdom of Great Britain and Northern Ireland),* UNRIAA, vol. XII (Sales No. 1963.V.3), pp. 83–153.

[10] *Yearbook ... 1978*, vol. II (Part Two), p. 14, para. 61.

[11] *Ibid*., para. 62.

[12] *Ibid.*, p. 16, para. 74.

[13] *Official Records of the General Assembly, Thirty-third Session, Sixth Committee*, 27th to 45th meetings (A/C.6/33/SR.27–45). The topic was raised in the Sixth Committee from 1980 until 1983, in 1988 and 1989 and again in 1991.

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. Secondly, 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 most-favoured-nation clause in its reports and final draft articles of 1978 have changed significantly.

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

Secondly, the GATT, which was a principal source for considering most favoured nation, has now been subsumed within the WTO. This has had the result of broadening the ambit of most favoured nation 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 most-favoured-nation provisions in the WTO agreements to be subject to authoritative interpretation.

Thirdly, 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 most-favoured-nation provisions.

Fourthly, resort to dispute settlement under investment agreements through the procedures of the International Centre for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules has resulted in the interpretation of most-favoured-nation provisions in the investment context.

17. These developments all have implications for the way most-favoured-nation 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 most-favoured-nation clauses are being used and how they operate in practice. The relationship between the general most-favoured-nation 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.[14]

18. Practice relating to most-favoured-nation clauses is also taking place in a context that is different from that which existed when the Commission last considered the clause. The 1978 draft articles relied heavily on the Charter of Economic Rights and Duties of States[15] when considering the relationship of the most-favoured-nation clause to the question of preferential treatment for developing States. 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 most-favoured-nation provisions has particularly come to the fore. The scope accorded to certain most-favoured-nation provisions and the differing approaches taken by various investment tribunals have created what is perhaps the greatest challenge in respect of most-favoured-nation 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 most-favoured-nation clause continues to be a critical factor in international economic relations among Member States. The continuing relevance of the most-favoured-nation clause could perhaps be viewed in the context of two phases. In the first phase, the growth of bilateral investment promotion and protection agreements in the 1990s underlined the continuing importance of the most-favoured-nation 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 most-favoured-nation clause.

21. Granting most-favoured-nation treatment for investment even at the pre-establishment stage is a feature in the free trade agreements that was not common in investment promotion and protection agreements in the past, where most-favoured-nation 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 most-favoured-nation clause in contemporary economic relations among States. A review of the role of the clause in the context of these new economic integration agreements merits closer study from a legal perspective.

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[14] *European Communities—Conditions for the Granting of Tariff Preferences to Developing Countries, AB-2004-1, Report of the WTO Appellate Body* (WT/DS246/AB/R), 24 April 2004.

[15] General Assembly resolution 3281 (XXIX) of 12 December 1974.

5. The challenges of the most-favoured-nation clause today

22. An exhaustive study of the practice of including most-favoured-nation 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 most favoured nation. However, in the field of investment, specific problems have arisen with the application of most-favoured-nation clauses that may have implications for the application of most favoured nation in other contexts as well.

23. The issue arose in *Maffezini*.[16] The claimant, Maffezini, an Argentine national, had brought a claim under the Agreement between the Argentine Republic and the Kingdom of Spain on the Reciprocal Promotion and Protection of Investments.[17] Spain argued that, under 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 most-favoured-nation provision in the investment agreement between Argentina and Spain, investment agreement (art. IV), which provided: "In all matters governed by this Agreement, such treatment shall be not less favourable than that accorded 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 Agreement on the reciprocal protection and promotion of investments between Chile and Spain,[18] 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 most-favoured-nation clause in the Argentina–Spain agreement, the claimant contended, it was entitled to the more favourable treatment that Chilean investors receive under the Chile–Spain bilateral investment agreement. As a result, it argued, its failure to commence a claim in the Spanish courts was not a barrier to bringing a claim under the Argentina–Spain investment agreement.

24. The tribunal rejected the argument of Spain that the most-favoured-nation clause in the bilateral investment agreement between Argentina and Spain applied only to substantive and not procedural provisions, pointing out that by its very terms the most-favoured-nation clause applied to "all matters governed by this Agreement". After a review of prior international jurisprudence and the treaty practice of Spain, the tribunal concluded that the claimant could use the most-favoured-nation clause in the bilateral investment treaty between Argentina and Spain to claim the better treatment provided in the investment agreement between Chile and Spain and thereby avoid the obligation of having to submit its claim to the domestic courts of Spain.

25. Subsequent ICSID tribunals have both followed[19] and distinguished[20] the *Maffezini* decision, although it is not clear that any consistent interpretation of most-favoured-nation provisions has emerged. The *Maffezini* decision opens the possibility that most-favoured-nation clauses could have an extremely broad scope. Such a clause has the potential of 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—sometimes 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 a most-favoured-nation 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 a most-favoured-nation clause "only those rights which fall within the subject-matter of the clause".[21] However, 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 a most-favoured-nation 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 view that a most-favoured-nation clause justifies reference to other investment agreements to establish what constitutes "fair and equitable treatment".[22] This, too, has led to uncertainty in the scope of a most-favoured-nation clause.

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

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[16] *Maffezini* v. *Kingdom of Spain*, *Case No. ARB/97/7, Decision of the Tribunal on objections to jurisdiction of 25 January 2000,* ICSID, *ICSID Review-Foreign Investment Law Journal*, vol. 16, No. 1 (2001), p. 1; the text of the decision is also available from http://icsid.worldbank.org.

[17] Signed at Buenos Aires on 3 October 1991, United Nations, *Treaty Series*, vol. 1699, No. 29403, p. 187.

[18] Signed at Santiago on 2 October 1991, *ibid.*, vol. 1774, No. 30883, p. 15.

[19] *Siemens A.G.* v. *Argentine Republic, Case No. ARB/02/8, Decision on jurisdiction of 3 August 2004*, ICSID, *Journal de droit international*, vol. 132 (2005); the text of the decision is also available from http://icsid.worldbank.org.

[20] See, for example, *Salini Costruttori S.p.A. and Italstrade S.p.A.* v. *the Hashemite Kingdom of Jordan*, *Case No. ARB/02/13, Decision on jurisdiction of 9 November 2004*, ICSID, *ICSID Review-Foreign Investment Law Journal*, vol. 20, No. 1 (2005), p. 148; the text of the decision is also available from http://icsid.worldbank.org..

[21] *Yearbook ... 1978*, vol. II (Part Two), p. 27.

[22] *MTD Equity Sdn. Bhd. and MTD Chile S.A.* v. *Chile*, *Case No. ARB/01/7, Award of 25 May 2004*, ICSID (see http://icsid.worldbank.org); *Pope and Talbot, Inc.* v. *Canada, Award of the NAFTA Tribunal of 10 April 2001*, ILR, vol. 122 (2002), p. 352.

29. At one level the problem is simply a matter of treaty interpretation. Most-favoured-nation clauses are worded differently in different agreements. Some are broad in scope and others are narrow. Some limit most-favoured-nation 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 a most-favoured-nation clause will depend in part on how the interpreter views the nature of such clauses.

30. If most-favoured-nation 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 a most-favoured-nation 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 such a provision. In this regard, the experience of the interpretation of the most-favoured-nation clause in the WTO context and in other areas may provide guidance for the interpretation of most favoured nation in the context of investment agreements.

6. What could the Commission usefully do?

31. It is clear that circumstances have changed significantly since the 1978 draft articles on most-favoured-nation 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 most-favoured-nation 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 still remain 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 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 most-favoured-nation 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 Commission can usefully do, as the United Nations organ concerned with the progressive development of international law and its codification.

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 most-favoured-nation clauses are matters of public international law. The central issue is how these clauses should 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 a most-favoured-nation clause. It engages our understanding of the role and function of most-favoured-nation clauses and of their relationship to the principle of non-discrimination in international law.

35. Other bodies have also been focusing on this topic. The Organisation for Economic Co-operation and Development (OECD) has produced a study on most-favoured-nation clauses,[23] as has the United Nations Conference on Trade and Development (UNCTAD).[24] 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 most-favoured-nation 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 most-favoured-nation clauses develop as it has been doing. Under 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 most-favoured-nation clauses. This would require an exhaustive analysis of the development of the nature, scope and underlying rationale for most-favoured-nation clauses, the existing most-favoured-nation jurisprudence in the various contemporary areas in which the clause operates today, the variety and uses of such clauses in contemporary practice, how these 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 most-favoured-nation clauses or it could be a series of model most-favoured-nation clauses or categories of clauses with commentaries on their interpretation. Either outcome could provide guidance to States in their negotiation of agreements with most-favoured-nation clauses and to arbitrators interpreting investment agreements.

39. The interpretation of most-favoured-nation 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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[23] OECD Directorate for Financial and Enterprise Affairs, "Most-favoured-nation treatment in international investment law", Working Papers on International Investment, No. 2004/2 (2004). Available from www.oecd.org/daf/inv/investment-policy/WP-2004_2.pdf.

[24] UNCTAD, "Most-favoured-nation treatment", *UNCTAD Series on issues in international investment agreements*, UNCTAD/ITE/IIT/10 (vol. III) (United Nations publication, Sales No. E.99.II.D.11) (1999).

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