University of Oxford, Faculty of Law

How much substantive protection should investment treaties provide to foreign investment?

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Abstract

This thesis contributes to academic debate about the question: how much substantive protection should investment treaties (IITs) provide to foreign investment? Chapters 5 and 6 argue that arbitral tribunals have interpreted fair and equitable treatment and indirect expropriation provisions of existing IITs in several different ways. Each of these interpretations is sketched as a model level of protection that could be explicitly adopted by states in the future, either through inclusion in new IITs, or through amendment to existing IITs. In this way, the thesis defines a range of prospective options available to states concerning the level of protection to provide to foreign investment through IITs. The thesis evaluates the relative desirability of these different levels of protection.

The thesis argues that different levels of protection should be evaluated according to their likely consequences. The thesis develops a framework for inferring and understanding the likely consequences of adopting different levels of protection. The framework proposes that the consequences of a given level of protection can be understood in terms of its likely effect on: economic efficiency; the distribution of economic costs and benefits; flows of foreign direct investment into host states; the realisation of human rights and environmental conservation in host states; and respect for the rule of law in host states. Within this framework, the thesis provides an assessment and synthesis of existing empirical evidence and explanatory theory so far as they relate to the consequences of IIT protections. It also specifies the normative criteria by which these consequences should be evaluated. Through the application of this framework, the thesis concludes that lower levels of protection of foreign investment are, in general, likely to be more desirable than higher levels of protection.

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Table of Abbreviations

Association of South East Asian Nations	ASEAN
Bilateral investment treaty	BIT
Double taxation treaty	DTT
European Court of Human Rights	ECHR
Energy Charter Treaty	ECT
European Union	EU
Friendship, Commerce and Navigation Treaty	FCN
Foreign direct investment	FDI
Fair and equitable treatment	FET
Chilean Foreign Investment Commission	FIC
Free trade agreement	FTA
Free Trade Commission of the North American Free Trade Agreements	FTC
International Center for the Settlement of Investment Disputes	ICSID
International Court of Justice	ICJ
Customary international law minimum standard for the treatment of aliens	IMS
International investment treaty	IIT
International Trade Organization	ITO
Most favoured nation	MFN

North American Free Trade Agreement	NAFTA
Organization for Economic Cooperation and Development	OECD
Permanent Court of International Justice	PCIJ
Canadian Pest Management Regulatory Agency	PMRA
Reports of International Arbitral Awards	RIAA
Agreement on Trade Related Aspects of Intellectual Property Rights	TRIPs
Agreement on Trade Related Investment Measures	TRIMs
United Nations	UN
United Nations Commission on International Trade Law	UNCITRAL
United Nations Commission on Trade and Development	UNCTAD
United Nations General Assembly	UNGA
United States of America	US
Value added tax	VAT
Vienna Convention on the Law of Treaties	VCLT
World Trade Organization	WTO

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Chapter 1 Introduction

1.1 Introduction to international investment treaties

Over the past fifty years, states have established a network of treaties that address the legal obligations of host states to protect foreign investment. The majority of these treaties are bilateral. Over 2600 bilateral investment treaties (BITs) have been signed; and nearly every state has signed at least one.[1] Roughly three-quarters of these BITs have entered into force.[2] While most early BITs were signed between a developed and a developing country,[3] BITs between developing countries are increasingly common.[4]

There is considerable uniformity in the structure and wording of BITs.[5] Two features that are common to the majority of BITs are of particular importance for this thesis. The first is that they provide a common set of substantive legal protections to foreign investment. Each signatory state is typically required to provide foreign investment from the other signatory state with fair and equitable treatment (FET), national treatment and compensation in the event of expropriation of the investment.[6] The second feature is that they allow foreign investors to bring claims that the host state has breached these protections directly to

[1] UNCTAD, 'Recent Developments in International Investment Agreements (July 2008 - June 2009)' [2009] International Investment Agreements Monitor 2; UNCTAD, 'Recent Developments in International Investment Agreements (2007 - June 2008)' [2008] International Investment Agreements Monitor 2.

[2] UNCTAD, 'The Entry into Force of Bilateral Investment Treaties (BITs)' [2006] International Investment Agreements Monitor 2.

[3] Rudolf Dolzer, 'The Impact of International Investment Treaties on Domestic Administrative Law' (2006) 37 International Law and Politics 952, 955.

[4] UNCTAD, *South-South Cooperation in International Investment Agreements* (United Nations 2007) 6.

[5] UNCTAD, *International Investment Agreements: Key Issues Volume 1* (United Nations 2004) 19.

[6] UNCTAD, *Development Implications of International Investment Agreements* (UNCTAD 2007) 2; Christopher Ryan, 'Meeting Expectations' (2008) 29 University of Pennsylvania Journal of International Law 725, 732.

investor-state arbitration.[7] If an arbitral tribunal determines that a host state has breached the applicable BIT, it will invariably award the investor-claimant compensation for the loss it suffered as a result of the breach. Such awards are readily enforceable.[8]

A number of bilateral and regional free trade agreements also provide foreign investors with the same set of substantive legal protections common to BITs, and allow investors to enforce these protections through investor-state arbitration. The most well known of these treaties is the North American Free Trade Agreement (NAFTA).[9] Similarly, the Energy Charter Treaty (ECT) confers legal protection on investments made by investors of a signatory state in the energy sector of any of the other fifty-one signatory states.[10]

This thesis concerns the set of treaties that place substantive obligations on host states relating to the protection of foreign investment *and* provide for compulsory investor-state arbitration of disputes arising under those substantive protections. The term international investment treaty (IIT) is used to refer to such treaties. This use of the term IIT is somewhat idiosyncratic, in that it excludes treaties that do not provide for compulsory investor-state arbitration. However, in the context of this thesis, distinguishing between treaties with and without compulsory investor-state arbitration is justified. While the latter are formally similar to the IITs with which this thesis is concerned, they have different practical implications as

[7] UNCTAD (n 5) 19.

[8] Arbitral awards are enforceable in the courts of states that have signed the Convention on the Settlement of Investment Disputes between States and Nationals of other States (18 March 1965) (1965) 4 ILM 524 art 54, if the tribunal is convened under the International Center for the Settlement of Investment Disputes (ICSID) rules; or the courts of the states that have signed the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (10 Jan 1958) 330 UNTS 38 art III, if the tribunal is convened under the United Nations Commission on International Trade Law (UNCITRAL) rules.

[9] North American Free Trade Agreement (adopted 17 December 1992, entered into force 1 January 1994) (1993) 32 ILM 296.

[10] The Energy Charter Treaty (17 December 1994) (1995) 34 ILM 360 art 13(1).

they cannot readily be enforced.[11] The subject matter of this thesis is the substantive obligations relating to the protection of foreign investment that IITs place on host states. The term 'IIT protection' is used to refer to these obligations.

1.2 Introduction to normative debate about IITs

There are at least two ways in which legal scholarship might be approached. One might ask what the law on a particular subject *is*.[12] This question invites doctrinal inquiry through an examination of authoritative sources and principles internal to a legal system. (In scholarship on international law, claims about what the law is are sometimes described as claims *de lege lata*.)[13] There is now a rich body of doctrinal scholarship that addresses the full range of legal questions raised by IITs.

Alternatively, one might ask whether the law on a particular subject matter is *desirable*.[14] This normative inquiry typically begins with a characterisation of what the law on a given subject is, but its primary objective is the evaluation of legal rules and institutions by external, normative criteria.[15] Normative inquiry treats law as the subject matter of inquiry, but the methods of inquiry are often drawn from other academic disciplines.[16] (In scholarship on international law, claims about how the law is developing, or should develop,

[11] Jason Yackee, 'Conceptual Difficulties in the Empirical Study of Bilateral Investment Treaties' (2008) 33 Brooklyn Journal of International Law 405, 426.

[12] Claims about what the law *is* are sometimes called 'propositions of law', eg Ronald Dworkin, *Law's Empire* (Hart 1998) 4.

[13] Hugh Thirlway, 'The Sources of International Law' in Malcolm Evans (ed), *International Law* (Oxford University Press 2003) 118.

[14] Throughout this thesis I use the term 'desirable' – in preference to terms such as 'just', 'fair' and 'legitimate' – to refer to normative evaluation in its most general sense.

[15] For a sophisticated discussion of the distinction between internal and external perspectives on law see H. L. A. Hart, *The Concept of Law* (2nd edn, Oxford University Press 1994).

[16] cf Richard Abel, 'What we talk about when we talk about law' in Richard Abel (ed), The Law and Society Reader (New York University Press 1995) 1.

are sometimes described as claims *de lege ferenda.*[17] Normative inquiry concerns questions about how the law should develop, so falls within the broad category of *de lege ferenda*. However, analyses of international law *de lege ferenda* often focus on questions of how international law is developing, through an examination of state practice and soft law that may crystallise into rules of international law in the future.[18] This is distinct from the evaluation of existing or proposed legal rules according to extra-legal criteria.)

There is an ongoing normative debate about whether IITs are desirable. Van Harten, for example, has argued that:

> [T]he advent of investment treaty arbitration stands out ... as an anomalous and exceptionally potent system that protects one class of individuals by constraining the governments that continue to represent everyone else.[19]

Further objections to IITs have been made on the related grounds that they limit states' ability to regulate their own economies;[20] and on the distinct grounds that states did not fully understand the legal implications of these treaties when they agreed to them.[21] Other commentators have articulated justifications for the existence of IITs, including arguments that they provide economic benefits to host states and that they encourage respect for the rule of law.[22]

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[17] *De lege ferenda* is defined in Bryan Garner (ed), *Black's Law Dictionary* (8th edn West Group 2004) 1292 as:

> A proposed principle that might be applied to a given situation instead or in the absence of a legal principle that is in force.

[18] eg Thirlway (n 13) 135.

[19] Gus van Harten, *Investment Treaty Arbitration and Public Law* (Oxford University Press 2007) 10.

[20] Howard Mann, 'The Right of States to Regulate and International Investment Law' (2002) 5 <http://www.iisd.org/pdf/2003/investment_right_to_regulate.pdf> accessed 26 November 2009.

[21] Gus van Harten, 'Five Justifications for Investment Treaties' (2010) 2 Trade, Law and Development 1, 19.

[22] Stephan Schill, 'Fair and Equitable Treatment, The Rule of Law and Comparative Public Law' in Stephan Schill (ed), *International Investment Law and Comparative Public Law* (Oxford University Press 2010) 176.

Normative debate about IITs often combines a number of conceptually distinct concerns – concerns about the provenance of IITs and concerns about the fairness of procedures and institutions of investor-state arbitration, among others. One recurring issue is the question of whether IITs provide unjustifiably generous (or unjustifiably inadequate) protection to foreign investment.[23] This thesis seeks to contribute to academic debate about the question: how much protection should investment treaties provide to foreign investment?

1.3 Research question and parameters

1.3.1 Research question

The research question that this thesis seeks to answer is: of the differing levels of investment protection implied by different interpretations of the FET and indirect expropriation provisions of IITs, which, if adopted, would be most desirable? From the outset, it is important to stress that this thesis does not attempt to resolve doctrinal debate about the 'correct' interpretation of FET and indirect expropriation provisions, nor does it purport to address debates in legal theory, so far as they concern the methodology by which one should identify the 'correct' interpretation of an IIT protection.[24] Rather, the thesis examines arbitral decisions interpreting existing provisions and identifies several different understandings of the extent of protection provided to foreign investment. Each of these understandings is sketched as a model that might be adopted in the future, either through amendment to existing treaties or by the incorporation of the preferred option in new treaties. It is these different levels of protection that are subject to evaluation.

[23] eg Santiago Montt, *State Liability in Investment Treaty Arbitration* (Hart 2009) 22.

[24] For discussion of the role of normative argument in the interpretation of IITs see Zachary Douglas, 'Nothing if Not Critical for Investment Treaty Arbitration' (2006) 22 Arbitration International 27, 51.

A further issue is the perspective from which the desirability of different levels of protection should be evaluated. The research question presupposes that the desirability of a given level of protection should be evaluated from a public interest perspective, rather than according to the interests of a particular individual or group. Adopting an impartial, public interest perspective is common in scholarship concerned with the normative evaluation of legal rules.[25] Determining what constitutes the 'public interest' in a given situation may raise complex and potentially contested questions. The normative framework developed in Chapter 4 offers an account of elements of the public interest that are likely to be affected by differing levels of IITs protections. The conclusions of this thesis are addressed to states – the authors of IITs – on the grounds that states should adopt legal rules that advance the public interest.

1.3.2 The justification for evaluating options that are derived from existing arbitral jurisprudence

An alternative research question might seek to determine the 'ideal' or 'optimum' level of investment protection. Such an attempt to determine the optimal level of protection would be a difficult, perhaps impossible, task. It would require the specification of a single evaluative metric capable of determining the way in which all competing considerations should be balanced – a methodological challenge that is discussed in greater detail in Chapter 3. This thesis attempts the more modest task of presenting a range of plausible options and seeking to determine which of the presented options is the most desirable.

The more immediate issue is the justification for deriving the options that are subject to evaluation from existing arbitral jurisprudence. This thesis could, instead, have evaluated alternative textual formulations of common IIT provisions – for example, by comparing the level of protection provided by a provision that requires compensation for 'indirect

[25] Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (Yale University Press 1970) 24-33;

expropriation' to that provided by a provision that requires compensation for measures with an 'effect equivalent to nationalization or expropriation'. Alternatively, the thesis could have evaluated existing textual formulations against new options – for example, by comparing the level of protection provided by a provision requiring 'fair and equitable treatment' to a hypothetical provision requiring 'adequate and tolerable treatment'.

The primary reason for evaluating options derived from existing jurisprudence is that the alternatives to be evaluated must, themselves, be defined with some degree of precision. To ask whether IITs should contain provisions requiring 'fair and equitable treatment' or another differently drafted provision is not a question that can sensibly be answered without providing a more precise articulation of the extent of protection each provision would provide. Existing IIT provisions are drafted in unusually vague terms, and their meaning has primarily been fleshed out through the process of interpretation and application by arbitral tribunals.[26] The examination of existing arbitral jurisprudence in Chapters 5 and 6 presents a range of alternative levels of protection, each of which is defined with sufficient precision to be amenable to evaluation.

There is a second justification for evaluating alternatives derived from existing jurisprudence, one that relates to the practicalities of treaty revision. Alternatives that are implied by different interpretations of existing provisions would be easier to adopt through amendments clarifying existing IIT provisions. Of course, it remains open to states to include whatever provisions on which they agree in future IITs. However, existing state practice

[26] Stephan Schill, *The Multilateralization of International Investment Law* (Cambridge University Press 2009) 355; Andrea Bjorklund, 'Investment Treaty Arbitral Decisions as Jurisprudence Constante' in Colin Picker, Isabella Bunn and Douglas Arner (eds), *International Economic Law* (Hart Publishing 2008) 277.

suggests a preference for the revision and clarification of existing standards, rather than the replacement of existing standards by those with no basis in current treaty practice.[27]

1.3.3 The justification for the specific focus on interpretations of FET and indirect expropriation provisions

The focus on the FET standard and indirect expropriation is justified by the fact that these are the two most important substantive protections contained in IITs, and that the interpretation of these two protections has proved contentious. That the interpretation of these standards has proved contentious is significant, as it means that tribunals have articulated a range of different understandings of the extent of protection conferred by each standard. This breadth of disagreement yields the set of options evaluated in this thesis. In the absence of space constraints the thesis would also evaluate differing levels of protection implied by different interpretations of the national treatment provisions of IITs.

1.3.4 Evaluation of legal rules, not evaluation of cases or arbitral decisions

An important characteristic of the research question is that it addresses the desirability of alternative legal *rules*, rather than evaluating the way in which individual *cases* were decided. In this thesis, the close examination of existing jurisprudence is used to define a set of alternative rules. The normative framework developed in Chapter 4 is used to evaluate these rules, rather than the decisions reached in the underlying cases. Evaluating legal rules invariably entails a higher degree of abstraction than evaluating decisions. In contrast to a specific focus on the issues raised in a given case, evaluating legal rules requires consideration of the implications for the full range of situations covered by the rule, including

[27] US Model Bilateral Investment Treaty (2004) <http://italaw.com/documents/USmodelbitnov04.pdf> accessed 30 January 2012, annex B; Canada Model Foreign Investment Protection Agreement (2004) <http://italaw.com/documents/Canadian2004-FIPA-model-en.pdf> accessed 30 January 2012, annex B; Colombia Model Bilateral Investment Treaty (2007) <http://italaw.com/documents/inv_model_bit_colombia.pdf> accessed 30 January 2012, art III(4).

its impact on the behaviour of legal actors in situations that do not ultimately result in legal disputes.[28]

1.3.5 *Prospective* evaluation of options for reform

A related characteristic of the research question is that it focuses on the *prospective* evaluation of a range of options that could be adopted. None of the options evaluated in this thesis has ever been adopted as a legal rule defining the extent of protection conferred to all foreign investment covered by the IITs in question. While the options under consideration are based on interpretations of existing IITs articulated in particular cases, these decisions do not define a level of protection that is applied consistently in all disputes. This thesis explores a set of prospective options, each of which would entail a degree of certainty about the level of protection provided to foreign investment.

The prospective nature of the research question has important implications for the consequentialist methodology applied in this thesis. Because none of the options under consideration has yet been adopted, there is no direct evidence of their consequences. Rather, the thesis is concerned with drawing probabilistic inferences about what the consequences of the options under consideration would be. These inferences are drawn from a combination of explanatory theory and existing indirect evidence of the effects of IIT protections.

1.3.6 The use of the deliberately open term 'adopt'

The research question requires prospective evaluation of alternative legal rules 'if adopted'. The use of the term 'adopt' is deliberately open; it avoids foreclosing questions about how the preferred level of protection should be ensured. This reflects the structure of thesis, which examines the level of protection that should be provided by IITs and then, subsequently,

[28] see, for an example of evaluation of legal rules on this basis, Guido Calabresi and Alvin Klevorick, 'Four Tests for Liability in Torts' (1985) 14 Journal of Legal Studies 585, 606-610.

considers the mechanics of legal reform required to ensure the desired level of protection. In practice, questions about the level of protection that should be provided and issues relating to the mechanics of legal reform are likely to be inter-related. Indeed, this thesis acknowledges this inter-relationship in electing to evaluate levels of protection implied by existing arbitral jurisprudence,[29] rather proposing new levels of protection with no basis in existing treaty or arbitral practice. Nevertheless, an academic inquiry must start somewhere. The inquiry in this thesis begins with an analysis of the level of protection that IITs should provided. Questions of how to ensure this level of protection are taken up in Chapter 7. The thesis envisages states adopting the preferred level of protection either through the amendment of existing IITs or the negotiation of new IITs.

1.3.7 Parameters

The research question takes as given that IITs exist; that they provide substantive protection to foreign investment; and that these protections can be enforced through investor-state arbitration. The research question focuses on the specific issue of the relative desirability of alternative levels of substantive protection that might be provided through IITs.

Two additional parameters should be acknowledged, both of which relate to the extent of substantive protection provided by IITs. The thesis does not consider the role that general exceptions in IITs play in qualifying state's obligations under IITs, or the role that the public international law doctrine of necessity plays in precluding wrongfulness of breaches of IITs that occur in emergency situations. This thesis is justified in overlooking general exceptions on the grounds that only a handful of the thousands of IITs that exist contain such

[29] see, section 1.3.2.

provisions.[30] The argument developed in this thesis would need to be modified to extend to IITs that do contain general exceptions. This thesis is justified in overlooking the doctrine of necessity on the grounds that this doctrine is applicable only in a very narrow set of emergency situations.[31] This thesis examines the desirability of alternative levels of protection so far as they apply in non-emergency situations.

1.3.8 The degree of generality of the analysis

The research question seeks to evaluate alternative levels of protection that might be provided in IITs generally. An alternative research question could have been framed with greater specificity in this respect. For example, the thesis could have asked: how much protection should a future India-US BIT provide to foreign investment? There are several justifications for reflecting on the level of protection that IITs should provide in general, rather than seeking to determine how much protection a specific IIT should provide.

The first two justifications concern the practicalities of the negotiation and application of IITs. The first stems from the fact that most existing state practice is driven by model investment treaties – template negotiating positions devised by a state and then offered to several other states.[32] As such, views about the level of protection that IITs should provide in general drive existing practice. The second justification is that, at the time a state negotiates an IIT, it cannot predict with certainty the types of investments that will qualify for protection under the treaty during the period it remains in force, or the range of regulatory actions that

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[30] Andrew Newcombe, 'General Exceptions in International Investment Agreements' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 358.

[31] *Draft Articles of the International Law Commission* (Yearbook of the International Law Commission Volume II, Part Two, 2001) art 25.

[32] Jeswald Salacuse, *The Law of Investment Treaties* (Oxford University Press 2010) 12-13; Schill, *The Multilateralization of International Investment Law* (n 26) 89; Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 8.

the state may wish to adopt during this period. If a state is to bind itself with respect to an uncertain range of regulatory actions that may affect an uncertain set of future investments, it would be well advised to reflect in more general terms on the merits of offering investment protection, rather than evaluating provisions solely through the lens of the investment relationship between the states at the time the IIT is signed.

A third justification is closely related to the second, and concerns the perspective of states that are both sources and recipients of foreign investment. Even when negotiating a single BIT, the interests of such states will tend toward levels of protection that are desirable when assessed from a general perspective. As Alvarez has argued:

> More countries than ever before are, like the PRC [People's Republic of China] and the United States, capital exporters as well as capital importers. The position of such countries in the investment regime might be said to approximate that of the individual in John Rawls' 'original position', that is, someone who is placed behind a veil of ignorance and does not know the social or economic position she occupies within society and is therefore incentivized to articulate principles of justice that are fair to all.[33]

The normative standpoint adopted in this thesis is akin to that of an 'original position' analysis, in that the thesis is not addressed to the self-interest of a particular state in a particular context.

The fourth and fifth justification concern the structure of IITs themselves. The fourth is that many IITs contain most favoured nation clauses.[34] For this reason, states will need to consider the possibility that the level of protection offered under any given IIT may become generalised by being made available to foreign investment covered by another IIT. The fifth is that several IITs have been interpreted as providing protection to investors of the corporate

[33] Jose Alvarez, 'The Once and Future Foreign Investment Regime' in M Arsanjani et al (eds), *Looking to the Future: Essay in Honor of Micahel Reisman* (Martinus Nijhoff 2010) 634.

[34] Schill, *The Multilateralization of International Investment Law* (n 26) 140.

nationality of the home state.[35] For this reason, states will need to consider the possibility that the level of protection offered under any given IIT will become generalised through being made available to investors that structure investments through corporate intermediaries in the 'home' state.[36]

A final justification is of a different character, as it concerns the relationship of this thesis to existing academic debate. The vast majority of academic writing treats the existing network of IITs as a single field of academic inquiry.[37] More than one commentator has described this network as constituting a 'regime';[38] another has argued that, in many respects, these treaties 'function analogously to a truly multilateral system'.[39] Without going so far as to endorse these claims, it is clear that the academic literature regards the set of existing IITs as raising common legal and policy issues. This thesis shares this premise.

1.4 Who is the intended audience of this thesis and what is its relevance to that audience?

This thesis is addressed to two different audiences. The primary audience of this thesis is the academic and policy community currently engaged in normative debate about IITs; a secondary audience is states themselves, in their capacity as drafters of IITs. The relevance of this thesis to each audience is explored below. From the outset, it is important to clarify that this thesis is not addressed to arbitral tribunals. Arbitral tribunals are charged with the task of

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[35] *CME v Czech Republic* Partial Award, 13 September 2001 [6]; *Tokios Tokeles v Ukraine* ICSID Case No ARB/02/3, Decision on Jurisdiction, 21 October 2005 [38].

[36] Schill, *The Multilateralization of International Investment Law* (n 26) 199.

[37] eg Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008); Salacuse (n 32) 5.

[38] Steven Ratner, 'Regulatory Takings in Institutional Context: beyond the Fear of Fragmented International Law' (2008) 102 American Journal of International Law 475, 517

[39] Schill, The Multilateralization of International Investment Law (n 34) 15.

interpreting IITs as they are currently drafted and in doing so they must apply the normal rules of treaty interpretation. Nor is this thesis addressed to investors or to states, in their capacity as respondents in particular cases.

1.4.1 The relevance of this thesis to existing academic and policy debate

This thesis is addressed to existing normative debate about IITs. The conclusions of this thesis are relevant in that they address the level of protection that IITs should provide to foreign investment – a question that is central to existing normative debate about IITs. The thesis defines a range of alternative levels of protection that could be included in IITs and provides a basis for evaluating the desirability of adopting each option.

The analysis developed in this thesis is relevant to existing debates in several more specific ways. First, the thesis clarifies the normative underpinnings of existing debate; it shows that disagreement about the level of protection that should be provided to foreign investment seldom stems from disagreement about which objectives are desirable. Secondly, the thesis shows that a range of causal assumptions about the likely consequences of IIT protections are implicit in existing debates; the thesis makes these assumptions explicit, examines whether they are theoretically coherent and tests them against available evidence. Thirdly, the thesis call into question the 'market' vs 'state' framing implicit in much of the existing academic discourse; the thesis argues that economic rationales provide a more limited justification for the protection of foreign investment than is generally supposed, and that 'economic' objectives are not necessarily in tension with 'non-economic' objectives. The contributions of this thesis to the existing literature are discussed in greater detail in Chapter 7.

1.4.2 The relevance of this thesis to states

This thesis is relevant to states in that it addresses a question of public policy that is currently controversial. The recent Australian government review of investment treaty practice and ongoing policy reviews in the US and the European Union have all considered the question of the extent of substantive protection that IITs should provide to foreign investment.[40] The thesis presents a range of potential options and develops a framework that provides the basis for inferring and evaluating the likely consequences of each option. The relevance of this sort of inquiry to the development of public policy is explained succinctly by Stokey and Zeckhauser:

> Models are of particular importance for public policy analysts, who are frequently forced to make policy recommendations in the face of a bewildering conglomeration of facts and estimates. The analyst must strip away the nonessentials that cloud a problem to expose the structural relationships among the important variables, so that the consequences of a particular policy choice may be predicted. The statement 'No one can predict what will happen,' while perhaps correct in a very narrow sense, is extraordinarily dangerous. It may allow the status quo to persist unquestioned, or it may lead more or less inevitably to the selection of the alternative that is most popular at the moment. We prefer the risks of decisions based on predictions, including predictions that admit to uncertainties, to decisions made by default. [41]

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[40] Productivity Commission, 'Bilateral and Regional Trade Agreements: Productivity Commission Research Report' (2010) <http://www.pc.gov.au/__data/assets/pdf_file/0010/104203/trade-agreements-report.pdf> accessed 30 January 2012; Advisory Committee on International Economic Policy, 'Report of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty' (2009) <http://www.uschamber.com/sites/default/files/grc/BITReviewReportandAnnexFinalVersion.pdf> accessed 30 January 2012, annex B. Compare the position of: European Commission, 'Towards a comprehensive European international investment policy' (2010) <http://italaw.com/documents/CommissionPolicyCommunication.pdf> accessed 30 January 2012, 8-9; with European Parliament 'European Parliament resolution of 6 April 2011 on the future European international investment policy' (2011) <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2011-0141&language=EN> accessed 30 January 2012 [15]-[26].

[41] Edith Stokey and Richard Zeckhauser, *A Primer for Policy Analysis* (Norton 1978) 8.

The conclusions of this thesis – a set of recommendations based on probabilistic inferences about the likely consequences of various policy options – are offered as policy-relevant insights on this basis.

The conclusions of this thesis are most relevant to the drafting of new multilateral IITs that bind a range of differently situated states, such as the Trans-Pacific Partnership currently under negotiation.[42] The conclusions of this thesis are also highly relevant to the drafting of new model BITs, which constitute template negotiating positions offered by a given state to a range of differently situated states. For example, the development of an EU model BIT is currently being considered. New treaties based on this model may ultimately end up replacing the 1200 existing BITs to which various EU member states are parties.[43]

While the conclusions of this thesis are not addressed to a particular set of states, if states do wish to tailor the level of substantive protection offered in a new BIT to the bilateral relationship in question (a practice that, historically, has been uncommon), the normative framework developed in Chapter 4 offers a basis for considering the level of protection that should be provided. For example: section 4.4 argues that different levels of protection are likely to entail different pattern of costs and benefits for states that are predominantly sources of foreign investment and those that are predominantly destinations for foreign investment; section 4.3.4 argues that IIT protections are likely to create greater net economic benefits in states in which discrimination against foreign investment is common; and section 4.6.4.2 suggests that developing states should pay particularly careful attention to the likely impact of adopting a given level protection on the way in which they exercise regulatory power.

[42] Office of the United States Trade Representative, 'Outlines of the Trans-Pacific Partnership Agreement' (2011) <http://www.ustr.gov/about-us/press-office/fact-sheets/2011/november/outlines-trans-pacific-partnership-agreement> accessed 22 February 2012.

[43] European Parliament (n 40) [B].

There are several other points at which the normative framework offers the basis for a more textured account of the consequences of adopting a given level of protection for a single IIT between particular states.

The conclusions of this thesis also entail a set of recommendations for the amendment or clarification of existing IITs. The mechanics of amendment and clarification of existing treaties are discussed in Chapter 7. This thesis argues that the best way to amend existing IITs would be to insert additional text, clarifying that existing provisions of the IIT entail the desired degree of protection.

1.5 Chapter plan

This thesis comprises seven chapters. Chapter 2 provides an analysis of the merits and limitations of methodologies used in normative scholarship relating to IITs. This analysis leads to the conclusion that most coherent criticisms of, and justifications for, IIT protections rely on consequentialist reasoning. Chapter 2 also identifies and articulates the normative premises in the existing literature that are capable of justifying a preference between different levels of IIT protection. One key insight that emerges from this review is that there is little disagreement in the existing literature about which norms are desirable. Normative disagreement stems from different assumptions about the consequences of IIT protections and different views about how competing norms should be prioritised. A second key insight that emerges from this chapter is that a range of causal assumptions about the consequences of IIT protections is implicit in existing normative debate.

Building on the analysis and critique of methodology in Chapter 2, Chapter 3 outlines and justifies the methodology of consequential evaluation.[44] Consequential evaluation

[44] The term 'consequential evaluation' is adopted from Sen's work. See, Amartya Sen, 'Consequential Evaluation and Practical Reason' (2000) 97 The Journal of Philosophy 477.

stipulates that different levels of IIT protection should be assessed by their likely consequences, evaluated according to specified normative criteria. Chapter 3 explains how the methodology of consequential evaluation is operationalised in this thesis. One important argument developed in Chapter 3 is that IIT protections should be understood as liability rules – rules that provide foreign investors with compensation for certain classes of loss caused by host state conduct.

Chapter 4 operationalises the methodology of consequential evaluation by constructing a framework that provides a basis for normative judgements about alternative levels of IIT protection. The chapter begins by framing empirical enquiry into the likely consequences of different levels of IIT protection. In doing so it draws heavily on the review and critique of existing normative scholarship in Chapter 2. It proposes a categorisation of the likely consequences of adopting a given level of protection that is as comprehensive as possible, its effects on: efficiency; the distribution of economic costs and benefits; flows of FDI into host states; the realisation of human rights and environmental conservation in host states; and respect for the rule of law in host states. It also articulates normative criteria by which the likely consequences should be evaluated. Within this framework, Chapter 4 then provides a review, assessment and synthesis of existing empirical evidence and explanatory theory so far as they relate to the likely consequences of different levels of IIT protection.

Chapters 5 and 6 examine arbitral decisions interpreting the FET standard and the concept of indirect expropriation, respectively. The function of each chapter is to identify alternative understandings of the level of protection provided by these provisions, which might be adopted in future IITs. Chapter 5 argues that, subject to certain caveats, the FET standard can be understood as comprising three distinct elements: protection of the investor's legitimate expectations; procedural review of government conduct; and substantive review of government conduct. It identifies four alternative interpretations of the legitimate

expectations element of the FET standard, three interpretations of the procedural review element and two interpretations of the substantive review element. Chapter 6 identifies five alternative interpretations of the concept of indirect expropriation. Each is sketched as a model level of protection.

Chapter 7 applies the normative framework developed in Chapter 4 to evaluate the differing levels of protection implied by alternative interpretations of the FET standard and of the concept of indirect expropriation. As such, Chapter 7 answers the research question: of the differing levels of investment protection implied by different interpretations of the FET and indirect expropriation provisions of IITs, which, if adopted, would be most desirable? It then considers the mechanics of incorporating the preferred level of protection into future and existing IITs. Chapter 7 concludes with reflections on the strengths and limitations of the normative framework, as revealed through the process of its application. The evaluation of alternative levels of protection in Chapter 7 constitutes the primary original contribution of this thesis to the existing literature. Other original contributions of this thesis include the normative framework developed in Chapter 4 and the analysis of arbitral reasoning provided in Chapters 5 and 6.

Chapter 2 Normative Debate about IITs and IIT Protections

2.1 Introduction

This chapter aims to draw out the methodological underpinnings of different strands of scholarship relating to IITs. This exposition is valuable in itself; greater clarity about methodology can shed new light on existing debates about IITs and their legal content. The chapter performs three more specific functions in the context of this thesis. It provides an analysis of the merits and limitations of existing methodological approaches in normative scholarship about IITs. This analysis justifies the methodology adopted by this thesis, which is introduced in Chapter 3. This chapter also identifies and critiques the premises that underpin normative debate about IIT protections. This analysis provides the basis for the normative framework developed in Chapter 4. Finally, the analysis shows that a range of causal assumptions about the consequences of IIT protections are implicit in existing normative debate. This provides a point of departure for Chapter 4, which seeks to make causal assumptions that underpin normative debate explicit and to consider whether these assumptions are theoretically coherent and supported by empirical evidence.

To assist in the elucidation of methodology, this chapter draws a distinction between doctrinal, empirical and normative claims. This partial taxonomy of claim-types is introduced in Section 2.2. Section 2.3 examines social scientific literature on IITs, and argues that much of this literature proceeds on the assumption that IITs seek to increase FDI and economic efficiency. Sections 2.4, 2.5 and 2.6 review scholarship debating the legitimacy or desirability of IITs. Section 2.4 focuses on normative critique of IITs; Section 2.5 focuses on normative justifications for IITs; and Section 2.6 considers appeals for ‘balance’ in debate about IITs. Each section seeks to identify the methodologies being used, assess the strengths and limitations of those methodologies and articulate the premises that underpin normative

conclusions. Section 2.7 offers a cautious synthesis of the normative premises that underpin debate about IIT protections.

2.2 A heuristic for understanding methodologies used in the literature on IITs

Methodology refers to a pattern of argument, in which certain types of claims are used to derive conclusions, which themselves are further claims. For the purposes of teasing out the methodologies used in literature on IITs it is helpful to distinguish between three types of claims: empirical claims, normative claims and doctrinal claims. These three claim-types do not provide a complete categorisation of all claims; rather, they provide a useful heuristic with which to unpick more complex forms of argument.

Empirical claims are descriptive; they purport to state facts or to assert causal connections between phenomena.[45] Normative claims are evaluative; they purport to state whether a given situation conforms to a prior idea or norm. Doctrinal claims, in the sense in which the term is understood in this thesis, are claims about what the law *is*, based on sources and principles of legal reasoning that are internal to law as a system. This understanding of doctrinal claims is derived from the writing of HLA Hart,[46] however, it is also consistent with the works of other legal theorists, notably Dworkin.[47]

The three types of claim may address the same subject matter, but they address it in different ways. To give a set of examples: the claim that 'ICSID decisions rendered in 2006

[45] While the notion of causation has, itself, been the subject of discussion in other contexts – eg H. L. A. Hart and Tony Honoré, *Causation in the Law* (2nd edn, The Clarendon Press 1985) 9 – there appears to be a consensus on the meaning of causation in social scientific scholarship on IITs. Given a common understanding of the notion of causation, any claim about the cause of, or explanation for, a phenomenon reduces to a set of empirical claims.

[46] Hart (n 15) 263 discussing the role of principles and reasoning in a source-based account of law.

[47] Dworkin (n 12) 3.

cited an average of 10 cases' is an empirical claim;[48] the claim that 'a de facto doctrine of precedent in international investment law would be desirable' is a normative claim;[49] the claim that 'a tribunal applying an IIT is not obliged, as a matter of law, to follow prior decisions that have interpreted identical treaty language' is a doctrinal claim.[50]

The type of conclusions sought to be derived from an argument defines and circumscribes the set of methodologies that might validly be employed to derive them. At the most basic level: empirical conclusions must rest on methodologies that collate and synthesise evidence; normative conclusions on methodologies that examine the conformity of phenomena with normative premises; and doctrinal conclusions on sources and forms of reasoning recognised by the legal system to which they relate. This is not to insist on an austere separation of different claim-types from each other. In practice many arguments rely on a variety of different claims. The validity of each claim made as a component of an argument may rely on a different methodological basis from the conclusion sought to be derived from the overarching argument. A simple example is the normative argument in favour of X advanced in the form: X causes Y (empirical claim); and Y is a good thing (normative claim). Indeed, this structure of argument is central to normative debate about IITs.[51]

2.3 Normative premises in social scientific scholarship on IITs

There is a substantial body of scholarship that draws on methodologies from political science, economics and international relations to propose causal theories and test empirical claims

[48] Jeffery Commission, 'Precedent in Investment Treaty Arbitration' (2007) 24 Journal of International Arbitration 129, 155.

[49] Gabrielle Kaufmann-Kohler, 'Arbitral Precedent' (2007) 23 Arbitration International 357, 378.

[50] Charles N. Brower, Michael Ottolenghi and Peter Prows, 'The Saga of CMS' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 851.

[51] The relationship between empirical evidence and causal theory is considered in greater detail in section 4.2.

about IITs. This section does not attempt to provide a full review of this literature. Rather, it attempts to show that characterisation of the objectives of IITs, and assessment of their effectiveness in realising these objectives, are central concerns in social scientific scholarship on IITs. Scholarship focusing on these questions embodies a shared belief that IITs are intended to achieve instrumental, economic aims – the attraction of foreign direct investment (FDI) and the creation of net economic benefits. Most writers within this literature appear to accept that these objectives are normatively desirable; more sophisticated contributions within this literature make such normative premises explicit.

2.3.1 'Rational actor' theories explaining why states sign IITs

A theoretical body of literature seeks to explain why developing states sign BITs.[52] The methodological basis for this work is the premise that states are unitary actors and that, in signing treaties, they act in their own interests. The majority of contributions to this literature rely on the further assumption that states are capable of rationally and accurately identifying their own interests – that they are rational actors.[53] These premises about the institutional and behavioural characteristics of states are assumed rather than proved. Yackee challenges the assumption that states act rationally. He argues that the acceptance of certain ideas among policy-makers – that BITs increase inflows of FDI and that FDI is necessary for economic development – rather than the accuracy of these ideas, explains states' behaviour.[54] The apparent paradox that developing countries signed BITs containing rules for the protection of

[52] This literature focuses on BITs, however its insights are applicable to the multilateral context.

[53] Implicit in the model of states' behaviour presented in the seminal article, Andrew Guzman, 'Why LDCs Sign Treaties that Hurt Them' (1998) 38 Virginia Journal of International Law 639, 669.

[54] Jason Yackee, 'Are BITs Such a Bright Idea? Exploring the Ideational Basis of Investment Treaty Enthusiasm' (2005) 12 University of California Davis Journal of International Law and Policy 195, 202.

foreign investment, while simultaneously rejecting identical rules in multilateral forums, has been a particular focus of explanatory theory.[55]

The prevailing view in explanatory theories of BITs, including Yackee's, is that capital-importing states sign BITs in an attempt to increase inflow of FDI.[56] These theories also agree that, were it not for increased FDI, BITs would be contrary to capital-importing states self-interest, as they limit states' ability to 'advance and protect their national interests'.[57] Given the central role of FDI in explanations for the existence of IITs, a number of studies have sought to investigate whether BITs are effective in attracting FDI.[58]

2.3.2 Theories explaining the content of IITs

A separate stream of scholarship attempts to explain the particular mix of provisions included in a typical BIT. Vandevelde is a key figure in this literature. His argument begins by distinguishing liberal economic theory from nationalist economic theory.[59] In his view, liberal economic theory is the theory that free markets provide the most efficient means to

[55] Zachary Elkins, Andrew Guzman and Beth Simmons, 'Competing for Capital' (2006) 60 International Organization 811, 841; Montt (n 23) 112; Ryan Bubb and Susan Rose-Ackerman, 'BITs and bargains' (2007) 27 International Review of Law and Economics 291, 307; Jean-Frederic Morin and Gilbert Gagné, 'What Can Best explain the Prevalance of Bilateralism in the Investment Regime?' (2007) 36 Journal of International Political Economy 53, 67.

[56] Yackee, 'Are BITs Such a Bright Idea?' (n 54) 202; Guzman (n 53) 670; Bubb and Rose-Ackerman (n 55) 302; Jeswald Salacuse and Nicholas Sullivan, 'Do BITs Really Work?' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 120; Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press 2010) 207; Stephania Bonilla and Rosa Castro, 'A Law-and-Economics Analysis of International Investment Agreements: Latin America' (2006) 12 <http://papers.ssrn.com/sol3/ Papers.cfm?abstract_id=1007684> accessed 24 June 2010; Gus van Harten, 'Private authority and transnational governance' (2005) 12 Review of International Political Economy 600, 609.

[57] Salacuse and Sullivan (n 56) 120; similarly, Guzman (n 53) 670; Bubb and Rose-Ackerman (n 55) 302; Sornarajah (n 56) 207.

[58] eg Tim Buthe and Helen V Milner, 'Bilateral Investment Treaties and Foreign Direct Investment' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 193.

[59] Kenneth Vandevelde, 'The Political Economy of a Bilateral Investment Treaty' (1998) 92 American Journal of International Law 621, 621.

allocate goods, services and investment flows.[60] This theory might, more precisely, be identified as neo-classical economic theory. He contrasts this with the theory of economic nationalism, a relatively open collection of interventionist theoretical responses to neo-classical economics based on the view that 'a state's economic policy should serve its political policy'.[61]

Vandevelde argues that BITs do not reflect economic liberalism in two key respects. First, economic liberalism calls for competitive equality between all investors, yet provides one group of foreign investors with a set of legal rights beyond those provided to local investors and foreign investors from countries not covered by a BIT.[62] Secondly, economic liberalism calls for unrestricted investment flows. However, BITs focus on the post-establishment rights of investment and allow states the discretion to exclude foreign investors.[63] (Although more recent US, Canadian and Japanese BITs do provide a right to pre-establishment national treatment.)[64] On the strength of these two arguments, Vandevelde suggests that BITs are better explained by the theories of interventionism and their associated political considerations, than a theory of economic liberalism.[65]

A distinct body of social scientific scholarship uses neo-classical economic theory to determine whether IIT protections are likely to improve economic efficiency (that is, whether

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[60] ibid 624.

[61] ibid 622; Kenneth Vandevelde, 'The Economics of Bilateral Investment Treaties' (2000) 41 Harvard International Law Journal 469, 476.

[62] Vandevelde, 'Political Economy of a BIT' (n 59) 630; also, Joseph Stiglitz, 'Regulating Multinational Corporations' (2008) 23 American University International Law Review 451, 549; Vaughan Lowe, *Changing Dimensions of International Investment Law* (University of Oxford Faculty of Law Legal Studies Research Paper Series, 2007) 48.

[63] Vandevelde, 'Economics of BITs' (n 61) 493.

[64] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 81.

[65] Vandevelde, 'Political Economy of a BIT' (n 59) 634.

they create net economic benefits).[66] This work has its intellectual roots in economic analyses of similar legal rules in domestic legal systems.[67] Its concern is to understand the economic consequences of IIT protections, rather than to explain their existence. In doing so, this literature brings greater rigour and specificity to Vandevelde's discussion of the implications of neo-classical economic theory for the design of international legal rules.

2.3.3 Summary of social scientific scholarship

The preceding discussion provides a brief overview of relevant social scientific scholarship on IITs. There is no need to resolve debates within this scholarship. For present purposes, it is sufficient to note that the majority of this literature attributes states' behaviour to their interest in attracting FDI. If one accepts that FDI flows have normative value, then it follows that explanatory theory and evidence examining the relationship between IITs and FDI is relevant to normative debate about IIT protections.

Vandevelde's explanation of IITs' content is also relevant to normative debate. Indeed, he follows his own explanatory arguments to normative conclusions, relying on the premise that economic liberalism (neo-classical economics and its focus on the maximisation of economic efficiency) should be the basis for investment policy.[68] On these grounds, he recommends that the pre-establishment rights of foreign investors should be strengthened and post-establishment protections should be weakened.[69] Similar arguments are put on a firmer theoretical footing in economic analyses of IITs. The normative conclusions of this literature

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[66] eg Emma Aisbett, Larry Karp and Carol McAusland, 'Police powers, regulatory taking and the efficient compensation of domestic and foreign investors' (2010) 86 The Economic Record 367

[67] Such as the seminal article, Lawrence Blume, Daniel Rubinfeld and Perry Shapiro, 'The Taking of Land' (1984) 99 The Quarterly Journal of Economics 71.

[68] Vandevelde, 'Political Economy of a BIT' (n 59) 635.

[69] Vandevelde, 'Economics of BITs' (n 61) 499.

stem from the premise that legal rules should be evaluated on the basis of whether they increase economic efficiency.

2.4 Normative critique of IITs and IIT protections

This section examines normative criticisms of IITs and IIT protections. It identifies six different strands of critique in the existing literature.[70] The discussion of each strand of critique seeks to articulate the methodology being used in the literature and the normative premises that underpin it. This analysis is the basis for reflection on the strengths and limitations of methodologies used in the existing literature and identification of norms capable of justifying a preference between alternative levels of IIT protection in section 2.7.

2.4.1 Historical methodology and normative conclusions

Critiques of IITs often rely on historical methodology to highlight the role that political power has played in the development of international investment law.[71] This form of enquiry examines the historical context in which treaties, arbitrations and other legal events occurred in order to provide explanations for them.[72] Historical inquiry usually continues to normative conclusions that challenge the legitimacy of international investment law. These claims rely on the implicit normative premise that law should not merely reflect the interests of the powerful. These conclusions are often linked to wider critiques of international economic relations.[73]

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[70] For an alternate catalogue of normative objections, see Jeffery Atik, 'Repenser NAFTA Chapter 11' (2003) 3 Asper Review of International Business and Trade Law 215.

[71] Muthucumaraswamy Sornarajah, 'Power and Justice' (2006) 10 Singapore Year Book of International Law 19, 31.

[72] eg Peter Muchlinski, 'The Rise and Fall of the Multilateral Agreement on Investment' (2000) 34 The International Lawyer 1033.

[73] eg Elizabeth Blackwood and Stephen McBride, 'Investment as the Achilles Heel of Globalisation?' (2006) 25 Policy and Society 43, 63.

Historical methodology is a useful tool for separating doctrinal claims from normative claims. For example, the observation that conditions attached to the grant of US foreign aid were responsible for Costa Rica accepting the jurisdiction of an ICSID tribunal in *Santa Elena v Costa Rica* shows that consensual arrangements can be legally effective, yet normatively questionable.[74] Historical methodology also provides some evidence for the claim that the US and European states promoted customary international law on investment to further their own interests.[75] This supports a related doctrinal critique of the development of customary international law of investment, which requires that *opinio juris*, rather than self-interest or coercion, guide state practice for it to have legal character.

That said, the vast number of IITs makes generalisation from specific historical experiences difficult. The hypothesis that BITs are imposed on developing countries by more powerful developed countries does not adequately account for the enormous diversity of bilateral relationships covered by near-identical BITs;[76] in particular, it appears inconsistent with the rapid growth of BITs between pairs of developing countries.[77] In the context of this thesis, there is a more specific limitation of historical scholarship. Historical sources provide a basis for normative debate about the way in which given legal rules and institutions were established. However, criticism of an existing rule's provenance does not provide a basis for prospective choice among a set of alternatives to that rule.

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[74] *Santa Elena v Costa Rica* ICSID Case No ARB(AF)/00/01, Final Award, 17 February 2000 (2000) 39 ILM 1317 [25]; Helms Amendment 22 USC (1994) s 2378 a.

[75] Sornarajah, *The International Law on Foreign Investment* (n 56) 38.

[76] The criticised hypothesis is advanced in Blackwood and McBride (n 73) 44.

[77] José Alvarez, 'Review: *Investment Treaty Arbitration and Public Law* by Gus van Harten' (2008) 102 American Journal of International law 909, 913. The spread of BITs between developing countries is documented in UNCTAD, *South-South Investment Agreements Proliferating* (United Nations 2006) 1.

2.4.2 Comparative methodology and normative conclusions

Another body of scholarship is grounded in comparative methodology. Comparative methodology is applied both at a micro-level of individual legal rules and a macro-level of legal systems and institutions.[78] Micro-level comparative scholarship on IITs compares treaty provisions to legal rules that perform the same function in other legal systems. The majority of micro-level comparative scholarship compares indirect expropriation under IITs to US regulatory taking jurisprudence.[79] Other contributions include comparisons between the indirect expropriation jurisprudence of arbitral tribunals and that of the European Court of Human Rights;[80] comparisons between the national treatment jurisprudence of arbitral tribunals and that of the World Trade Organisation;[81] and Kantor's argument that certain

[78] 'This distinction between micro and macro comparative scholarship has been drawn by others, including: Konrad Zweigert & Hein Kotz, Introduction to Comparative Law (2nd edn, Oxford University Press 1998) 4; and, in the context of investment treaties, Valentina Vadi 'Critical Comparisons: the Role of Comparative Law in Investment Treaty Arbitration'(2010) 39 Denver Journal of International Law and Policy 67, 82.

[79] Including, Jon Stanley, 'Keeping Big Brother out of our Backyard' (2001) 15 Emory International Law Review 349; Ethan Shenkman, 'Could Principles of Fifth Amendment Takings Jurisprudence Be Helpful in Analyzing Regulatory Expropriation Claims Under International Law?' (2002) 11 New York University Environmental Law Journal 174; Gary Sampliner, 'Arbitration of Expropriation Cases under U.S. Investment Treaties - A Threat to Democracy of the Dog That Didn't Bark' (2003) 18 ICSID Review - FILJ 1, 11; Vaughan Lowe, 'Regulation or Expropriation?' (2002) 55 Current Legal Problems 447, 461; Barry Appleton, 'Regulatory Takings' (2002) 11 New York University Environmental Law Journal 35, 36; Edward Graham, 'Regulatory Takings, Supernational Treatment, and the Multilateral Agreement on Investment' (1998) 31 Cornell International Law Journal 599, 604.

[80] eg Helen Mountfield, 'Regulatory Expropriations in Europe' (2002) 11 New York University Environmental Law Journal 136; Helene Ruiz Fabri, 'The Approach Taken by the European Court of Human Rights to the Assessment of Compensation for "Regulatory Expropriations" of the Property of Foreign Investors' (2002) 11 New York University Environmental Law Journal 148; Ursula Kriebaum, 'Regulatory Takings' (2007) 8 Journal of World Investment and Trade 717, 730; Thomas Wälde and Abba Kolo, 'Environmental Regulation, Investment Protection and 'Regulatory Taking' in International Law' (2001) 50 International and Comparative Law Quarterly 811, 824.

[81] Federico Ortino, 'From "non-discrimination" to "reasonableness"' (2005) 15 <http://centers.law.nyu.edu/jeanmonnet/papers/05/050101.html> accessed 28 October 2009.

decisions interpreting the fair and equitable treatment standard resemble the pre-1934 US constitutional doctrinal of substantive due process.[82]

Micro-level comparative scholarship relies on doctrinal argument to determine what the law on a certain point is. It then follows a relatively settled pattern of comparison and contrast to arrive at a set of empirical claims about the differences and similarities between the legal rules under examination. This process often informs a subsequent normative conclusion; however, a set of observations about similarities and differences is not sufficient grounds for normative judgement. While there is intuitive appeal to the claim that IITs should not confer greater protection on private property than is common in domestic legal systems – an argument made most forcefully by Montt[83] – without recourse to extra-legal normative criteria the assertion does not withstand scrutiny. For this comparative argument to avoid circularity, the possibility that domestic legal systems confer unjustifiably inadequate protection on private property must be taken seriously.[84]

Macro-level comparative scholarship argues that international investment law – as a system of institutions, procedural rules and substantive rules – is analogous to a given body of domestic law. There are two key strands within this literature: one arguing that international investment law is analogous to domestic constitutional law; another arguing that it is analogous to domestic administrative or public law.

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[82] Mark Kantor, 'Fair and Equitable Treatment' (2006) 5 The Law and Practice of International Courts and Tribunals 231.

[83] 'It is shocking to consider that a United States investor may lose a case against its government in the United States Supreme Court, a German investor may lose the same case in the *Bundesverfassungsgericht* (Constitutional Court), and a French investor may lose it in the *Conseil d'État*, but, nevertheless, that any of them may win it against a Sri Lanka or Bolivia on the basis of such open-ended BIT principles as no expropriation without compensation or FET.' Montt (n 23) 22.

[84] To be fair, Montt avoids this circularity by invoking the normative premises that justify domestic law. See text at n 99.

The definitive work comparing IITs to public law is Van Harten's *Investment Treaty Arbitration and Public Law*.[85] Van Harten asserts that international investment law is analogous to domestic public law in that it allows individuals to seek redress for a state's improper exercise of regulatory powers.[86] Because of this similarity in function, Van Harten argues that adjudication under IITs should conform to public law norms of accountability, openness, coherence and independence.[87] Van Harten also argues that the substantive rules of IITs should be interpreted to incorporate principles of deference to state judgement akin to principles of deference in domestic administrative law.[88] This claim is not developed, and is ultimately subsumed into his arguments for changes in the institutions and procedural rules governing the settlement of investor-state disputes under IITs.[89]

Poirier makes a more explicit normative argument for deference, without relying so heavily on the public law analogy.[90] He contends that legal regimes embody negotiated social settlements that balance the interests of property protection against the interests advanced through regulation. These social settlements are legitimately renegotiated by the polity governed by them from time to time.[91] This justifies the claim that IITs should defer to the balance struck between the protection of property rights and regulatory prerogatives within a

[85] van Harten, *Investment Treaty Arbitration and Public Law* (n 19); cf arguments that IITs have no precise analogy in domestic legal systems, Dolzer and Schreuer (n 64) 3; Annie Leeks, 'The Relationship Between Bilateral Investment Treaty Arbitration and the Wider Corpus of International Law' (2007) 65 University of Toronto Faculty of Law Review 1, 3; Heikki Marjosola, 'Public/Private Conflict in Investment Treaty Arbitration - a Study on Umbrella Clauses' [2009] Helsinki Law Review 103, 104.

[86] van Harten, *Investment Treaty Arbitration and Public Law* (n 19) 67.

[87] ibid 152.

[88] ibid 144.

[89] ibid 151.

[90] Marc Poirier, 'The NAFTA Chapter 11 Expropriation Debate through the Eyes of a Property Theorist' (2003) 33 Environmental Law 851, 918.

[91] ibid 858.

given state. On this basis, he suggests that investment disputes should be litigated in national courts, with international arbitration available to review whether these proceedings were tainted by discrimination only after local remedies have been exhausted.[92] Recognising that this institutional reform is impractical, he argues that the second-best solution would be an appellate mechanism to review arbitration decisions,[93] thereby reaching normative conclusions similar to Van Harten's.

Schneiderman uses the comparison of IITs to domestic constitutional law as a basis for critique. He establishes the analogy to constitutional law by arguing that 'investment rules can be viewed as a set of binding, irrevocable constraints designed to insulate economic policy from majoritarian politics.'[94] In Schneiderman's view, constitutional rules should provide only the minimum legal basis necessary for societal dispute resolution.[95] This justifies his normative conclusion, a complete rejection of IITs in favour of national statutory alternatives.[96]

Critiques based on comparisons of IITs to public law and constitutional law are united by a common norm: that international legal adjudication should show a degree of deference to judgements made in the domestic political sphere. Constitutional critiques rely on a stronger formulation of the principle of deference – thus, Schneidermann rejects any international review of governmental measures affecting foreign investors. Public law critiques propose a weaker principle of deference, one that would allow international review of governmental measures provided that institutions of adjudication and review possessed the

[92] ibid 919.

[93] ibid 924.

[94] David Schneiderman, *Constitutionalizing Economic Globalization* (Cambridge University Press 2008) 3.

[95] ibid 236.

[96] ibid 232.

characteristics of domestic courts exercising powers of judicial review. Both sets of critiques are primarily directed to the institutional structure of adjudication and review established by IITs.

Deference might also be invoked as a norm to evaluate alternative levels of substantive protection.[97] This argument has recently been made by Montt, relying on the comparative justification that domestic courts show a high degree of deference to governmental measures that do not entail the total destruction of property rights.[98] To the extent that this comparative methodology has a normative basis, it is through the incorporation of normative arguments about the appropriate level of deference to the exercise of public power from domestic law.[99] This engages a rich and sophisticated literature, which spans constitutional theory, public law and, more recently in the UK, human rights review. A full assessment of this literature is beyond the scope of this thesis. Nevertheless, three basic justifications for deference in a domestic context can be identified. A brief assessment of these justifications shows that the case for treating the principle of deference to domestic political judgements as a primary norm that international legal rules should promote is less compelling than it might initially appear.

Democratic legitimacy is the foundation of many arguments for judicial deference.[100] A simplified version of this argument is that judges are not elected, so courts should defer to substantive value judgements made by elected officials, and those exercising authority

[97] An argument for deference to host states in the interpretation and application of exceptions to IIT protections is made in William Burke-White and Andreas von Staden, 'Private Litigation in a Public Sphere' (2010) 35 Yale Journal of International Law 283, 297.

[98] Montt (n 23) 22, 229.

[99] ibid 166.

[100] ibid 227; David Dyzenhaus, 'The Politics of Deference' in Michael Taggart (ed), *The Province of Administrative Law* (Hart Publishing 1997) 305; *International Transport Roth GmbH v Secretary of State for the Home Department* [2002] EWCA Civ 158, [2003] QB 728, [81] – [87].

delegated by elected officials.[101] This argument has less force in the context of IITs, because many of the states bound by them are not democratic.[102] Any case for deference to public decision-making in the interpretation of IIT protections cannot be premised on the assumption that public decision-making is necessarily democratic.

A second key argument for deference in public law is based on the recognition that certain policy choices require the reconciliation of competing interests. Primary decision-makers have greater expertise in determining relevant facts and greater experience in striking appropriate trade-offs between competing interests than courts do.[103] This reluctance to intrude into the merits of policy choices is based on the presumption that granting a public law remedy would invalidate the value judgement made by the decision maker, circumscribing the scope of its policy choice.[104] The situation under an IIT is different. The remedies awarded in investor-state arbitration do not invalidate a state's policy choice; they allow a state to maintain its preferred policy and compensate the foreign investor.[105]

Thirdly, as a question of comparative scholarship, the degree of deference (if any) that judges in domestic courts show to the substantive judgements made in the political sphere varies significantly. One of the grounds on which it varies is the extent to which the normative justification for judicial review rests on the protection of private rights, as opposed to the promotion of reasoned public decision-making. Thus, in judicial review of the exercise

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[101] Luc Tremblay, 'The Legitimacy of Judicial Review' (2005) 3 International Journal of Constitutional Law 617, 619. Similarly, Barnali Choudhury, 'Recapturing Public Power' (2008) 41 Vanderbilt Journal of Transnational Law 775, 782.

[102] Alvarez (n 77) 913.

[103] Christopher Edley, *Administrative Law* (Yale University Press 1990) 34; similarly, Burke-White and von Staden (n 97) 329.

[104] *Associated Provincial Picture Houses v Wednesbury Corporation* [1948] 1 KB 223.

[105] Schill, *The Multilateralization of International Investment Law* (n 26) 250.

of public power under the Equal Protection Clause of the Fourteenth Amendment, the US Supreme Court usually applies the deferential standard of rational basis review.[106] However, in cases where the exercise of public power infringes a 'fundamental right' or involves the use of a 'suspect classification' the Court applies the less deferential standard of strict scrutiny.[107] This illustrates that deference to public power is not necessarily a normative premise. Rather, normative premises about the interests that should be protected by judicial review entail conclusions about the appropriate degree of deference.

This third issue is borne out by the fact that the comparison of IITs to domestic public law has also been used as a foundation for arguments for less deference: the claim that the protections of IITs should be interpreted so as to provide greater certainty as to the extent of investors' rights.[108] In making this argument, Sanders draws on the work of Hayek, who argues that legal rules protecting private rights from interference by the state should be clear and certain, as governments' are capable of exploiting their power over individuals.[109]

In a similar vein, there are scholars who accept the analogy of international investment law to constitutional law, but arrive at different normative conclusions to Schneiderman. Schill, for example, argues that international investment law does possess a threshold level of legitimacy as a constitutional system, as states have consented to the creation of the system.[110] Petersmann goes further, implying that the constitutional character

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[106] *United States v Carolene Products Company* 504 US 144 (1938) 152.

[107] *Skinner v State of Oklahoma, ex. rel. Williamson* 316 US 535 (1942) 541; *Korematsu v United States* 323 US 214 (1944) 216.

[108] Anthony Sanders, 'Of All Things Made in America why are we Exporting the *Penn Central* Test?' (2010) 30 Northwestern Journal of International Law and Business 339, 372. Richard Epstein, *Takings* (Harvard University Press 1985) 148 develops a similar argument at great length, in the context of the US 5th Amendment.

[109] Sanders (n 108) 372.

[110] Schill, *The Multilateralization of International Investment Law* (n 26) 373.

of IITs is sufficient to demonstrate their legitimacy.[111] He argues that the substantive and procedural rules of IITs should draw more heavily on the 'constitutional principles' that protect the rights of individuals in international economic law and human rights law.[112]

There is no need to resolve these debates among proponents of comparative methodology. The purpose of this review is simply to show that comparative methodology is, foremost, an empirical methodology. Comparative claims describe, with attention to certain features, the similarities and differences of the legal phenomena compared. Moving from comparative observations to normative conclusions requires a set of normative criteria by which the compared subjects should be evaluated. The difference between Van Harten's and Sanders' arguments illustrates that relying on a different set of normative premises will lead to different normative conclusions, notwithstanding a shared set of observations about the similarities between given legal regimes. To the extent that comparative scholarship is relevant to normative debate about the level of protection the should be provided by IITs, it raises the question of the appropriate level of deference to the judgements made in the domestic political sphere. This section argues that the question of deference to government decision-makers is better understood as a conclusion that follows from premises about the primary norms that law should promote, than as a primary norm itself.

2.4.3 Razian rule of law norms

Another critique of IITs relies directly on principles that relate to desirable formal characteristics of law and legal institutions that apply the law. These principles – that the

[111] Ernst-Ulrich Petersmann, 'Human Rights, Constitutionalism, and 'Public Reason' in Investor-State Arbitration' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 883.

[112] Ernst-Ulrich Petersmann, 'Constitutional Theories of International Economic Adjudication and Investor-State Arbitration' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 193.

judiciary should be independent, courts open and accessible and natural justice observed; and that the law should be prospective, open and clear, and relatively stable – can all be rationalised as components of Raz's conception of the rule of law.[113] A different conception of the rule of law, one that also speaks to the substantive content of law, is sometimes invoked as justification for IITs.[114] There is no need to determine which is the 'correct' conception of the rule of law. Instead, grouping institutional, procedural and formal critiques together under the Razian banner, while addressing the substantive norms raised by other scholars separately, is a way of clarifying existing arguments in the literature that use the phrase 'the rule of law' to mean different things.[115]

Scholarship relying on Razian rule of law principles is predominantly concerned with the institution of compulsory investor-state arbitration.[116] However, discussion that invokes Razian norms does overlap with debate about the level of substantive protection provided by IITs in two ways. The first is via empirical debate about the impact of the institution of investor-state arbitration on the interpretation of substantive IIT protections.[117] The critique is that arbitrators, as an epistemic community, have an interest in expanding the system of investor protection, so tend to interpret treaty standards broadly.[118] This hypothesis is plausible; however, to credibly test it an anthropological and sociological inquiry into the

[113] Joseph Raz, 'The Rule of Law and its Virtue' (1977) 93 The Law Quarterly Review 195, 202.

[114] Kenneth Vandevelde, *Bilateral Investment Treaties: History, Policy and Interpretation* (Oxford University Press 2010) 2; text to n 177.

[115] Similarly, Paul Craig, 'Formal and Substantive Conceptions of the Rule of Law' [1997] Public Law 467, 487.

[116] Gus van Harten, 'Perceived Bias in Investment Treaty Arbitration' in Michael Waibel and others (eds), *The Backlash against Investment Arbitration* (Kluwer Law International 2010) 434.

[117] Muthucumaraswamy Sornarajah, 'The Neo-Liberal Agenda in Investment Arbitration' in Wenhua Shan, Penelope Simons and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart 2008) 215.

[118] ibid 218; van Harten, *Investment Treaty Arbitration and Public Law* (n 19) 152.

opinions and motivations of arbitrators would be necessary.[119] No such research has been undertaken.

A second point of intersection concerns the effect of investor-state arbitration on the development of the rule of law in states that are parties to IITs.[120] Although this literature is primarily concerned with understanding the consequences of investor-state arbitration, it reflects the premise that greater respect for the rule of law in domestic legal systems would be desirable. While this literature does not attempt to examine the impact of individual IIT protections on the degree of respect for the rule of law in domestic legal systems, it necessarily entails the view that substantive protections that lead to greater respect for the rule of law would be more desirable.

2.4.4 Sovereignty as a norm

The norm that the sovereignty of states should be respected is often invoked to critique the substantive content of IITs.[121] The meaning of sovereignty is not explored in detail in this literature, but it appears that the concept refers to a state's entitlement to exercise power within its territory, subject only to the constraints of its own laws.[122] The use of this unqualified conception of sovereignty as a basis for normative critique is problematic. It is self-evident that IITs place limits on host states' sovereignty, in the sense that IITs require

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[119] Scott Shackelford, 'Investment Treaty Arbitration and Public Law, by Gus van Harten' (2008) 44 Stanford Journal of International Law 215, 218.

[120] Tom Ginsburg, 'International Substitutes for Domestic Institutions' (2005) 25 International Review of Law and Economics 107, 121; Susan Franck, 'Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law' (2007) 19 Global Business and Development Law Journal 337, 365.

[121] Wenhua Shan, 'Calvo Doctrine, State Sovereignty and the Changing Landscape of International Law' in Wenhua Shan, Penelope Simons and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart 2008) 311; Sornarajah, 'The Neo-Liberal Agenda in Investment Arbitration' (n 117) 205; Olivia Chung, 'The Lopsided International Investment Law Regime and Its Effect on the Future of Investor-State Arbitration' (2007) 47 Virginia Journal of International Law 953, 963; Tai-Heng Cheng, 'Power, Authority and International Investment Law' (2005) 20 American University International Law Review 465, 507.

[122] eg Choudhury (n 101) 777.

states to compensate foreign investors for certain – otherwise permissible – exercises of government power.[123]

Most scholars recognise that, despite its rhetorical appeal, an unqualified norm of sovereignty is not a coherent basis for normative critique.[124] The more coherent objection is that IITs interfere with states' ability, in practice, to implement certain policies within their territory.[125] These arguments are often articulated through the language of a sovereign's 'right to regulate'.[126] For example, Muchlinski argues that IITs should respect a state's 'right to regulate for legitimate policy purposes', while accepting the legitimacy of restrictions on sovereignty that prevent 'abuses of power which impact adversely on investors'.[127] Disagreement about the extent of legitimate interference with sovereignty can then only be resolved by recourse to norms other than sovereignty: debate about whether the benefits of IITs are sufficient to justify the added difficulty and expense to a state in pursuing certain policies.[128] Engagement with this debate, in turn, entails consideration of empirical questions

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[123] Thomas Wälde, 'Interpreting Investment Treaties' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 735.

[124] This argument is made succinctly in, Vaughan Lowe, 'Sovereignty and International Economic Law' in Wenhua Shan, Penelope Simons and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart 2008) 79.

[125] Catherine Yannaca-Small, *"Indirect Expropriation" and the "Right to Regulate" in International Investment Law* (Working Papers on International Investment, 2004) 2; Jeff Waincymer, 'Balancing Property Rights and Human Rights in Expropriation' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 307; Jan Paulsson, 'Indirect expropriation' (2005) 3 <http://www.oecd.org/dataoecd/5/52/36055332.pdf> accessed 24 November 2009. Here, I rely on the understanding of sovereignty proposed in Robert Howse, 'Sovereignty, Lost and Found' in Wenhua Shan, Penelope Simons and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart 2008) 61.

[126] Mann (n 20) 5; Suzanne Spears, 'The Quest for Policy Space in an New Generation of International Investment Agreements' (2010) 13 Journal of International Economic Law 1037, 1042.

[127] Peter Muchlinski, 'Policy Issues' in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law* (Oxford University Press 2008) 14.

[128] Calvin Hamilton and Paula Rochwerger, 'Trade and Investment' (2005) 18 New York International Law Review 1, 21; Ryan (n 6) 761; Joachim Karl, 'International Investment Arbitration' in Wenhua Shan, Penelope Simons and Dalvinder Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart 2008) 244.

about the extent to which IITs do create benefits and entail added difficult in pursuing specific policies.

There is a wider body of literature that discusses the concept of sovereignty that is not commonly referred to in debates about IITs. It is worth noting that the conclusion of the previous paragraph – that a sovereignty-based critique is only coherent to the extent that it relies on norms other than an appeal to states' entitlement to exercise unrestricted power within their own territory – is consistent with this wider literature. Recent contributions from Jackson and Sarooshi both argue that the normative value of sovereignty rests on the extent to which it embodies other, prior, norms. In Jackson's view a normatively justifiable conception of sovereignty should reflect a 'pragmatic functionalism' about whether given regulatory powers should be exercised at the national or an international level.[129] In Sarooshi's view, sovereignty retains normative force to the extent it can be justified by norms of 'legitimacy, autonomy, self-determination, freedom, accountability, security and equality'.[130]

2.4.5 Human rights norms

Many recent critiques of IITs are framed in terms of human rights.[131] Human rights norms provide a link to doctrinal arguments, because there is a body of law – human rights law – which embodies human rights norms.[132] Human rights arguments are raised in a number of

[129] John H. Jackson, 'Sovereignty-Modern' (2003) 97 American Journal of International Law 782, 801.

[130] Dan Sarooshi, 'The Essentially Contested Nature of the Concept of Sovereignty' (2004) 25 Michigan Journal of International Law 1107, 1115.

[131] Hamilton and Rochwerger (n 128) 45; Will Schreiber, 'Realizing the Right to Water in International Investment Law' (2008) 48 Natural Resources Journal 431; Ryan Suda, 'The Effect of Bilateral Investment Treaties on Human Rights Enforcement and Realization' (2005) <http://www.law.nyu.edu/global/workingpapers/2005/ECM_DLV_015787> accessed 19 April 2010; Charles H. Brower, 'NAFTA's Investment Chapter' (2003) 36 Vanderbilt Journal of Transnational Law 1533; Luke Eric Peterson and Kevin Gray, *International Human Rights in Bilateral Investment Treaties and in Investment Treaty Arbitration* (2003) 22.

[132] James Harrison, 'Human Rights Arguments in *Amicus Curiae* Submissions' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 413.

different contexts in debate about IITs, including in critique of the institution of investor-state arbitration. This thesis is interested in the role of human rights norms as criteria to evaluate the level of substantive protection provided by IITs. To reach this scholarship it is first necessary to distinguish doctrinal debate about the relevance of human rights law to the application and interpretation of IITs.

There are two scenarios in which human rights law might, arguably, be relevant in the resolution of a claim that a state has breached an IIT protection: a state's human rights obligations could displace an inconsistent obligation under an IIT; or a state's human rights obligations could be invoked to assist in the interpretation of the scope of a state's obligations under an IIT. The former situation is unlikely. If two rules of international law are inconsistent one will displace the other, according to the principles of *lex specialis* and *lex posterior*.[133] Inconsistency does not arise by virtue of the fact that the two rules apply to the same conduct simultaneously. State conduct in a given field is regularly subject to obligations arising from different sources and these 'multiple obligations regulating the same conduct are perfectly capable of coexistence'.[134] It must be impossible for a state to comply simultaneously with its investment treaty obligations and human rights obligations for them to be inconsistent, in the doctrinal sense.[135] It is difficult to imagine a situation where a state's

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[133] James Crawford, 'Continuity and Discontinuity in International Dispute Settlement' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 816.

[134] ibid; similarly, Study Group of the International Law Commission, *Fragmentation of International Law* (2006) [4]:

> *The principle of harmonization*. It is a generally accepted principle that when several [legal] norms bear on a single issue they should, to the extent possible, be interpreted so as to give rise to a single set of compatible obligations.

[135] Moshe Hirsch, 'Interactions between Investment and Non-Investment Obligations' in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law* (Oxford University Press 2008) 174; Marek Wierzbowski and Aleksander Gubrynowicz, 'Conflict of Norms Stemming from Intra-EU BITs and EU Legal Obligations' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 546.

human rights and IIT obligations would be doctrinally inconsistent.[136] Even in situations where the tension between investment and human rights obligations is obvious, a state retains the option to follow whatever course of conduct is necessary to comply with its human rights obligation so long as it directly expropriates (and compensates) any foreign investment that would be affected by that conduct.[137]

The improbability of a state's human rights and IIT obligations being inconsistent means that most doctrinal scholarship focuses on the role of international human rights law in IIT interpretation.[138] The starting point for an inquiry is Article 31 (3) (c) of the VCLT; the threshold question is whether a human rights instrument ratified by all the parties to the investment treaty in question is a 'relevant rule of international law applicable in the relations between the parties'.[139] Even if human rights obligations meet this requirement, there remains a difficult doctrinal question of the weight to be given to human rights law in the process of interpreting IITs.[140] An alternative approach in doctrinal investigation of the role of human rights obligations in IIT interpretation relies on inductive methodology. It involves the compilation and classification of references to human rights law and cases in international

[136] Waincymer (n 125) 308; Valentina S. Vadi, 'Reconciling Public Health and Investor Rights' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 485; Suda (n 131) fn 420.

[137] *Suez, Sociedad General de Aguas de Barcelona and Vivendi Universal AWG Group v Argentina* ICSID Case No ARB/03/19, Decision on Liability, 30 July 2010 [262].

[138] Bruno Simma and Theodore Kill, 'Harmonizing Investment Protection and International Human rights' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 691.

[139] Vienna Convention on the Law of Treaties (adopted 23 May 1969 , entered into force 27 January 1980) 1155 UNTS 331.

[140] Campbell McLachlan, 'The Principle of Systemic Integration and Article 31(3) (c) of the Vienna Convention' (2005) 54 International and Comparative Law Quarterly 279, 310.

investment arbitrations.[141] For the purpose of this thesis it is not necessary to resolve these doctrinal issues. The purpose of this brief survey is to distinguish doctrinal debate about the role of human rights obligations in the interpretation of IITs from normative debate about the consequences of IITs for the realisation of human rights.

A distinct strand of scholarship criticises IITs on the grounds that they jeopardise the realisation of human rights norms *in practice*. This scholarship may refer to human rights instruments in the elucidation of human rights norms, but the argument does not depend on these norms having a legal character.[142] The most common methodology is case-study – either actual or hypothetical – which illustrates the consequences of an IIT protection being applied in a given factual scenario. Common criticisms of IITs are that investors may 'challenge human rights inspired measures';[143] that investment treaties 'have the potential to restrict state capacity to regulate in the public interest in the sphere of human rights';[144] and that investment law may cause 'regulatory chill' of measures that are effective in realising human rights.[145]

While this normative scholarship rests on a different methodological basis to doctrinal argument, the distinction between the two is not always clear. For example, Kriebaum uses the case study of a hypothetical water concession to show 'conflict' between a state's human

[141] eg Clara Reiner and Christoph Schreuer, 'Human Rights and International Investment Arbitration' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 88; Moshe Hirsch, 'Investment Tribunals and Human Rights' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 99; Luke Eric Peterson, *Human Rights and Bilateral Investment Treaties* (Rights and Democracy 2009) 21.

[142] Suda (n 131) fn 214.

[143] Peterson and Gray (n 131) 23.

[144] Suda (n 131) fn 19.

[145] High Commissioner for Human Rights, *Economic, Social and Cultural Rights: Human rights, trade and investment* (2003) 21; Gus van Harten and Martin Loughlin, 'Investment Treaty Arbitration as a Species of Global Administrative Law' (2006) 17 European Journal of International Law 121, 131.

rights and IIT obligations.[146] In the case study, an investor who has been awarded an exclusive water concession significantly increases the price of water. The putative conflict is that the state must rescind the contract, breaching the investment treaty, or fail in its obligation to ensure the right to water within its territory. Despite asserting a legal conflict, Kriebaum does not examine what is required of the state by each of its legal obligations. Such an examination would show that there is no doctrinal conflict in the case study. The state's obligation in human rights law is to ensure that residents have affordable access to water;[147] the state's obligation under the IIT is to treat the investor's interest in the water concession fairly and equitably and not to expropriate the concession without paying compensation. To satisfy both obligations, the state could have written a universal access obligation into the original concession contract, reflecting its human rights obligations in the terms of the contract.[148] Alternately, the state could intervene *ex post* by subsidising the supply of water to ensure affordable access, without affecting the price charged by the investor, or it could simply expropriate the concession and compensate the investor. There may be a number of policy reasons why each of these solutions is unsatisfactory, but this serves to emphasise that Kriebaum's concerns are normative rather than doctrinal in character.

This failure to distinguish between doctrinal and normative claims leads to confusion in the 'debate' on human rights and investment law. The most strident human rights critiques of IITs are based on normative claims, even when these critiques invoke the legal character of human rights.[149] The central claim in this literature is that limitations placed on the state by

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[146] Ursula Kriebaum, 'Privatizing Human Rights' (2006) 3 Transnational Dispute Management 1, 6.

[147] General Comment No. 15 'The Right to Water' (2002) E/C.12/2002/11 [26]-[27].

[148] Bruno Simma, 'Foreign Investment Arbitration: a Place for Human Rights?' (2011) 60 International and Comparative Law Quarterly 573, 595.

[149] Howard Mann, 'International Investment Agreements, Business and Human Rights' (2008) 15 <http://www.iisd.org/pdf/2008/iia_business_human_rights.pdf> accessed 27 November 2009.

IITs have negative consequences for the realisation of human rights. On the other side, the principal set of responses is that IITs and human rights law are not antagonistic: because there is no doctrinal inconsistency between them;[150] because human rights jurisprudence is sometimes used to interpret IITs;[151] and because state conduct which violates an investor's human rights may also constitute a breach of an IIT.[152] Thus framed, the two sides of the debate do not join issue. It is possible for all the doctrinal claims about the relationship between IITs and human rights law to be correct and also for IITs to have the consequence of jeopardising the realisation of human rights.

This review of existing critiques of IITs on human rights grounds leads to three conclusions. First, some scholars criticise IITs for interfering with the realisation of human rights. This criticism is not answered by the claim that IITs are consistent with international human rights law. Secondly, to the extent that human rights norms provide a basis for critique of IIT protections, they rely on implicit causal assumptions about the likely consequences of a given protections for the realisation of human rights. The argument is not that IIT protections directly interfere with the human rights of individuals in host states – IITs govern the relationship between foreign investors and host states, not the relationship between foreign investors and individuals – but that the effect of IIT protections is to discourage states from taking effective steps to realise human rights in practice.[153] Thirdly, there is little disagreement in this literature about the particular norms that fall within the set of human

[150] James Fry, 'International Human Rights Law in Investment Arbitration' (2007) 18 Duke Journal of Comparative and International law 77, 100.

[151] ibid 83.

[152] Andrew Newcombe and Lluis Paradell, *Law and Practice of Investment Treaties* (Kluwer Law International 2009) 273.

[153] Jasper Krommendijk and John Morijn, ''Proportional by What Measure(s)? Balancing Investor Interests and Human Rights by Way of Applying the Proportionality Principle in Investor-State Arbitration' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 423.

rights norms, nor dissent from the premise that the realisation of these norms would be desirable.

2.4.6 Environmental norms

Environmental norms – that natural resources, ecosystems and biodiversity have intrinsic normative value and should be conserved – are another basis for critique of IITs. The structure of argument in this literature is relatively clear, so can be summarised succinctly. The basic argument is that IITs threaten host states' ability to enact environmental measures. The argument relies on the implicit causal assumption that IITs discourage decision-makers in host states from introducing environmental regulations because they require host states to compensate foreign investors when environmental measures affect their interests and, further, because the create uncertainty about the scope of non-compensable regulatory activity.[154] These concerns are both based on consequential reasoning. They are both potentially relevant to the evaluation of IIT protections, as they are linked to the scope of legal protection provided by IITs.

A related critique of IITs is grounded in the concept of sustainable development. In the literature on IITs, the concept is usually defined as 'development that meets the needs of the present without compromising the ability of future generations to meet their own needs'.[155] This definition provides clarity on the meaning of 'sustainability' – a specific form of inter-generational equity – without shedding much light on the concept of 'development'

[154] Vicki Been and Joel Beauvais, 'The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine' (2003) 78 New York University Law Review 30, 132; Kyla Tienhaara, *The Expropriation of Environmental Governance* (Cambridge University Press 2009) 276; J. Martin Wagner, 'International Investment, Expropriation and Environmental Protection' (1999) 29 Golden Gate University Law Review 465, 467.

[155] Spears (n 126) 1067; Marie-Claire Cordonier Segger and Andrew Newcombe, 'An Integrated Agenda for Sustainable Development in International Investment Law' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 105, both citing Bruntland Report of the World Commission on Environment and Development, Our Common Future, Annex, UN Doc A/42/427 (1987).

that is subject to the constraint of sustainability. In practice, the composite phrase 'sustainable development' functions either as a portmanteau for a collection of incommensurable norms that include environmental conservation, economic growth, realisation of human rights and distributive justice;[156] an interstitial principle – a secondary norm governing the balancing of competing primary norms such as these;[157] or as both a portmanteau and an interstitial norm.[158] Critiques of IITs that rely on the concept of sustainable development tend to invoke both understandings of sustainable development: their criticism is that the economic benefits that flow from IITs are insufficient to justify their other consequences, articulated in terms of environmental, distributive justice, or human rights norms.[159]

While acknowledging the normative concerns that underpin these criticisms of IITs, there is no need to add sustainable development to the set of primary norms capable of justifying a preference between different levels of IIT protection. To the extent that sustainable development functions as a portmanteau of other primary norms, these norms can be examined with greater precision if they are identified specifically. To the extent that

[156] Graham Mayeda, 'Sustainable International Investment Agreements' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 542.

[157] Spears (n 126) 1070, citing Vaughan Lowe, 'Sustainable Development and Unsustainable Arguments' in Alan Boyle and David Freestone (eds), *International Law and Sustainable Development* (Clarendon Press 1999) 31.

[158] Cordonier Segger and Newcombe (n 154) 104, citing *New Delhi Declaration on Principle of International Law Relating to Sustinable Development*, ILA Resolution 3/2002, Annex, UN Doc A/57/329 (2002).

[159] Mayeda (n 156) 772; Marie-Claire Cordonier Segger and Avidan Kent, 'Promoting Sustainable Investment through International Law' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 772; cf Andrew Newcombe, 'Sustainable Development and Investment Treaty Law' (2007) 8 Journal of World Investment and Trade 357, 359.

sustainable development operates as a secondary, or interstitial, norm, its significance is examined below.[160]

2.5 Normative justifications for IITs, and IIT protections

This section examines normative justifications of IITs and IIT protections, and identifies three different strands of justification in the existing literature. The discussion of each strand seeks to articulate the methodology being used in the literature and the normative premises that underpin it. This analysis is the basis for reflection on the strengths and limitations of methodologies used in the existing literature and identification of norms capable of justifying a preference between different levels of IIT protection in section 2.7.

2.5.1 Realisation of treaties' purpose as a norm

A wide range of contributions in the existing literature refer to IITs' purpose in the course of argument. Discussions of purpose raise two sets of issues: how IITs' purpose should be characterised; and the significance of IITs' purpose in wider argument. The prevailing view in social scientific literature is that developing states sign IITs for the purpose of attracting FDI.[161] In this literature a treaty's purpose is invoked as an *explanation* for states' decision to sign that treaty; that is, a given characterisation of purpose is used as an element in empirical argument.

In contrast, within doctrinal literature there is a lively debate about how IITs' purpose should be characterised (including debate of whether it is appropriate to characterise all IITs as having the same purpose). It is undisputed, in this debate, that the significance of an IIT's purpose is that Article 31(1) of the VCLT requires a treaty's provisions to be interpreted 'in

[160] Text to n 191.

[161] Text at n 56.

the light of its object and purpose.'[162] The central issue in this debate is a question of characterisation – the level of generality with which IITs' purpose should be characterised. As IITs confer legal protection on foreign investment, one view is that the purpose of IITs is simply to protect foreign investment.[163] A broader view is that the purpose of IITs is the protection and promotion of foreign investment – the protection of investment being the specific means by which IITs promote investment.[164] Other scholars argue for more general understanding of IITs purpose. According to these views, the promotion of foreign investment is not an end in itself; rather, the purpose of IITs is to promote economic growth, sustainable development or some other ultimate objective by encouraging foreign investment.[165]

This thesis does not attempt to resolve debate about how IITs' 'object and purpose' should be characterised in the context of doctrinal argument; nor to determine the way in which a treaty's purpose, once identified, should be incorporated into the legal reasoning of arbitral tribunals.[166] Both questions turn on doctrinal determinations of the sources and principles of international law, among them: the significance of a treaty's title and preamble; the relevance of subsequent state practice; and the role, if any, of extra-legal normative

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[162] VCLT (n 139).

[163] José Alvarez and Kathryn Khamsi, 'The Argentine Crisis and Foreign Investors' in K. Sauvant (ed), *Yearbook on International Investment Law and Policy 2008-2009* (Oxford University Press 2009) 412; *Pope & Talbot v Canada* Award on the Merits of Phase 2, 10 April 2001 [116].

[164] Salacuse (n 32) 109; Stephan Schill, 'Multilateralizing Investment Treaties Through Most-Favored-Nation Clauses' (2009) 27 Berkley Journal of International Law 496, 549; *SGS v Philippines* ICSID Case No ARB/02/6, Decision on Objections to Jurisdiction, 29 January 2004 [116].

[165] Charles H. Brower, 'Obstacles and Pathways to Consideration of the Public Interest in Investment Treaty Disputes' in Karl Sauvant (ed), *Yearbook on International Investment Law & Policy* (Oxford University Press 2009) 274; *Saluka Investment BV v Czech Republic* Partial Award, 17 March 2006 [300]; *Plama Consortium Ltd v Republic of Bulgaria* ICSID Case No ARB/03/24, Award, 27 August 2008 [167].

[166] An example of doctrinal critique of a tribunal's legal reasoning on the grounds that it is inconsistent with the IIT in question's purpose is Kathleen Claussen, 'The Casualty of Investor Protection in Times of Economic Crisis' (2009) 118 Yale Law Journal 1545, 1553.

claims in doctrinal argument.[167] (It is worth noting that existing doctrinal debate about IITs' purpose does incorporate normative claims – for example, the argument that the attraction of foreign investment is merely the means by which IITs pursue some more general purpose depends on the premise that foreign investment has no intrinsic normative value.[168])

For the purposes of this thesis, it is sufficient to note that realisation of a treaty's purpose should not be the sole criterion by which new provisions that might be included in that treaty are evaluated. It is entirely possible for a treaty to embody a purpose that is normatively undesirable;[169] or for a treaty's proximate purpose to constitute a well-intentioned, yet misguided, attempt to achieve some higher order objective; or for a provision of a treaty to cause unjustifiable harm to other interests in the pursuit of a narrow, albeit desirable, purpose. In each of these situations provisions that are less effective in realising the treaty's purpose could be more desirable from an extra-legal perspective. Even if debate about the characterisation of IITs' purpose could be resolved, different levels of IIT protection should not be assessed solely on the basis of the extent to which they realise IITs' purpose.[170]

2.5.2 Consent as a norm

The fact that states have consented to investment treaties by ratifying them makes them authoritative sources of international legal obligations. However, consent is also deployed as

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[167] For discussion of these doctrinal issues, see Anthea Roberts, 'Power and Persuasion in Investment Treaty Interpretation' (2010) 104 American Journal of International law 179, 198. For an empirical account of the sources arbitral tribunals use to interpret IITS, see Ole Kristian Fauchald, 'The Legal Reasoning of ICSID Tribunals' (2008) 19 European Journal of International Law 301, 322.

[168] Implicit in Anne van Aaken, 'Opportunities for and Limits to an Economic Analysis of International Law' (2010) 23 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1635390> accessed 29 August 2010.

[169] John Finnis, 'The Truth in Legal Positivism' in R. George (ed), *The Autonomy of Law* (Clarendon Press 1996); Hart (n 15) 184.

[170] cf Ratner (n 38) 520-524.

a norm to justify the desirability of IITs.[171] The assumptions underlying this norm seem to be: that states would only consent to IITs if it were in their interests to do so; and that any treaty that is in the interests of all the parties to it is, by definition, desirable (regardless of its impact on those that are not a party to it). Accepting consent as the sole basis for normative judgement would entail the conclusion that any freely-accepted treaty provision is, by definition, legitimate and desirable.

Consent is a weak basis for normative judgements about IITs. Historical scholarship offers examples of situations in which a state's consent is legally effective, yet motivated by pressures unrelated to the content of the treaty.[172] Moreover, the link between consent and self-interest is based on the assumption that national bureaucracies are sufficiently well-resourced to determine whether a set of legal arrangements accords with the national self-interest.[173] Those who rely on consent as a norm do not establish the validity of this assumption, and there is anecdotal evidence to suggest that the bureaucracies of developing countries do not always function accordingly.[174] Both observations demonstrate that consent does not necessarily demonstrate self-interest.

In the context of this thesis, there is a further, more significant, limitation of consent as a norm. Consent may be capable of justifying claims about the legitimacy of IITs and their

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[171] Daniel Price, 'Private Party vs Government, Investor-State Dispute Settlement' (2000) 26 Canada United States Law Journal 107, 113.

[172] Text at n 74.

[173] van Harten, 'Five Justifications for Investment Treaties' (n 21) 19.

[174] Damon Vis-Dunbar and Lauge Skovgaard Poulsen, 'Reflections on Pakistan's investment-treaty program after 50 years' (2009) <http://www.investmenttreatynews.org/cms/news/archive/2009/03/16/pakistans-standstill-in-investment-treaty-making-an-interview-with-the-former-attorney-general-of-pakistan-makhdoom-ali-khan.aspx> accessed 27 November 2009; similarly, *Wintershall Aktiengesellschaft v Argentina* ICSID Case No ARB/04/14, Award, 8 December 2008 [85].

provisions. However, invoking states' consent offers little assistance in evaluating the desirability of new provisions that states might agree to adopt in the future.

2.5.3 Norms of good governance

The rule of law is also invoked as a justification for IITs and for the substantive protections contained in them. In justifications of IITs, 'the rule of law' is used to describe two different bundles of norms, both of which go beyond the Razian norms that are deployed as a basis for critique of international investment arbitration. The first set of norms described by the rule of law is somewhat opaque, but seems to reflect a belief that that the resolution of investment disputes by legal adjudication, rather than by negotiation or political pressure, is more consistent with the rule of law.[175] This premise might provide justification for compulsory investor-state arbitration, but it does not provide a criterion for evaluating different provision defining the level of substantive legal protection to be applied in investor-state arbitration. The second way that the rule of law is used in justification of IITs is to refer to a particular set of substantive and procedural principles that govern the exercise of public power. This bundle of norms includes, but goes beyond, Razian rule of law norms. A number of scholars have advanced this argument.[176] The most comprehensive statement of this argument is made in a recent book by Vandevelde.

Vandevelde argues that the principles of reasonableness, security (of property and contract), non-discrimination, transparency and due process are elements of the rule of law.[177]

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[175] Sampliner (n 79) 41; UNCTAD, *Development Implications* (n 6) 5; Paulsson (n 125) 2; Vandevelde, *Bilateral Investment Treaties* (n 114) 119; Charles N. Brower and Lee Steven, 'Who Then Should Judge?' (2001) 2 Chicago Journal of International Law 193, 202.

[176] See, Dolzer, 'The Impact of International Investment Treaties on Domestic Administrative Law' (n 3) 971; Thomas Wälde and Todd Weiler, 'Investment Arbitration under the Energy Charter Treaty in the light of new NAFTA Precedents' (2004) 1 Transnational Dispute Management 1, 10; Schill, 'Fair and Equitable Treatment' (n 22) 159; Charles N. Brower and Stephan Schill, 'Is Arbitration a Threat or a Boon to the Legitimacy of International Investment Law?' (2009) 50 Chicago Journal of International Law 471, 487.

[177] Vandevelde, *Bilateral Investment Treaties* (n 114) 2.

Although Vandevelde describes these norms are components of the rule of law, it is useful to label them 'good governance' norms, so as to distinguish them from the more limited Razian conception of the rule of law. Much of his book comprises doctrinal argument, which attempts to show that the substantive terms of BITs, and decision interpreting and applying those terms, can be rationalised as a coherent reflection of these good governance principles.[178] His argument also has a strong normative element. He contends that these principles have 'intrinsic worth' that would justify the existence of BITs, even if BITs are unsuccessful in achieving their instrumental, economic objectives.[179]

The initial difficulty with Vandevelde's argument is the assertion that the five norms that he identifies have 'intrinsic worth'. This assertion is arguable, but Vandevelde offers little by way of argument to support it. His collective justification for the five norms is exclusively instrumental: that that they are components of 'liberal legalism', which, in turn, is associated with economic growth.[180] To the extent that he does justify his choice of norms individually, security (of property and contract) rests exclusively on instrumental grounds,[181] while non-discrimination, and transparency rest primarily on instrumental grounds.[182] There is no inconsistency in suggesting that a given norm may have both intrinsic and instrumental value. However, to the extent that the desirability of a norm rests on its instrumental value, it requires empirical justification – demonstration that compliance with norm in the circumstances in question leads to desirable consequences (in this case, economic prosperity).

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[178] ibid 12.

[179] ibid 119.

[180] ibid 114. Similarly, Schill, 'Fair and Equitable Treatment' (n 22) 176.

[181] Vandevelde, *Bilateral Investment Treaties* (n 114) 78.

[182] ibid 337, 397.

Although Vandevelde does not provide a justification for intrinsic value of the security of property, it is worth pausing at this point to ask whether there is any coherent justification for his view. Waldron has usefully divided philosophical justifications for the protection of property rights into libertarian and Hegelian arguments. It seems unlikely that the Hegelian view – that the intrinsic value of property rights stems from property-ownership's role in the ethical development of the individual – could justify the protection of investment property owned by corporations.[183] On the other hand, libertarian theories of distributive justice, which are based on the entitlement to property justly acquired – might provide justification for the view that the security of foreign investment has intrinsic normative value.

A second difficulty with Vandevelde's argument relates specifically to the concept of reasonableness on which he relies. He contends that it is intrinsically desirable for a government's conduct to be rational, in the sense of being 'reasonably related to a legitimate host-state regulatory objective.'[184] This conception of reasonableness comprises two component norms: that government should pursue legitimate objectives; and that, in the pursuit of legitimate objectives, government conduct should satisfy the criterion of means-ends rationality. The latter norm is uncontroversial. A government is more likely to be effective in realising a normatively desirable objective if its conduct has some plausible causal connection to the realisation of that objective; that is, if its conduct satisfies the criterion of means-ends rationality.[185] The former component norm – that government should

[183] Jeremy Waldron, *The Right to Private Property* (Clarendon Press 1990) 351, discussing the Hegelian justification for property rights, and comparing it to the libertarian view.

[184] Vandevelde, *Bilateral Investment Treaties* (n 114) 109.

[185] The principle that *administrative* conduct should satisfy the criterion of means-ends rationality can also be justified by a formal conception of the rule of law, see Tracey Hickman, 'The Reasonableness Principle' (2004) 63 Cambridge Law Journal 166, 170. The underlying norm is that the exercise of conferrals of discretion should be circumscribed by clear and stable rules, such as the principle that discretionary authority only be exercised

pursue legitimate objectives – presupposes some normative account of the criteria by which legitimate objectives should be identified. Vandevelde does not attempt to provide such an account. To the extent that such an account is implicit in his writing, it is through the suggestion that 'politically motivated' conduct does not pursue a legitimate objective.[186] While this position is arguable, it is not self-evident that it is intrinsically undesirable for a government to be motivated by political pressure; indeed, many democratic political theories imply the opposite.[187]

A final qualification to Vandevelde's argument is that reasonableness, non-discrimination, transparency and due process, all belong to a class of norms that relate to the exercise of government power. However, IIT protections are not enforced by institutions that are capable of constraining the exercise of public power. An arbitral tribunal's finding that a governmental measure has breached an IIT triggers an obligation to pay compensation to the investor, not an order invalidating or annulling the measure.[188] Accordingly, the argument that IIT protections can be justified by good governance norms depends on an implicit causal assumption – that such legal rules have the consequence of encouraging governments to exercise power in a certain way.

This critique of Vandevelde's norms of good governance informs four conclusions that are relevant to this thesis. The first is that his assertion that the security of property is intrinsically desirable is not justified; presumably, it depends on an unarticulated libertarian theory of distributive justice. The second is that his conception of reasonableness cannot

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for the purposes for which it was conferred, see Raz (n 113) 200. This rationale does not apply to legislative conduct.

[186] Kenneth Vandevelde, 'A Unified theory of Fair and Equitable Treatment' (2010) 43 International Law and Politics 43, 59

[187] Amartya Sen, *Development as Freedom* (Oxford University Press 1999) 182.

[188] Schill, 'Fair and Equitable Treatment' (n 22) 170.

substitute for an account of the primary norms by which the impact of IIT protections on government conduct should be evaluated. The third is that the norm that government conduct should satisfy the criterion of means-ends rationality is a specific iteration of a more general principle: that the realisation of primary norms is desirable. The fourth is that his conception of reasonableness, along with norms of non-discrimination, transparency and due process, relies on implicit causal assumptions about the impact of IIT protections on government conduct.

2.6 The role of secondary norms in normative debate

A final set of norms is invoked by both critics and supporters of IITs. These norms – balance, sustainable development (in its interstitial sense) and good judgement – all relate to the reconciliation of competing, incommensurable objectives. They are secondary norms that mediate between primary norms. A brief survey of references to these norms illustrates that they are relied upon in different contexts, often to justify very different conclusions.

Vandevelde argues that IITs should strike a balance between the interests of the host state and the interests of the home state. He argues that BITs are formally balanced, because both parties take on equal obligations under the treaty, but are often unbalanced in practice, as one state is more commonly a recipient of foreign investment than the other.[189] A second debate concerns the balance between the interests of the host state and the interests of foreign investors, as reflected in the architecture of IITs. One common criticism, on this basis, is that IITs are unbalanced because they confer benefits on foreign investors without imposing any duties on them.[190] A third issue relates to the institution of investor-state arbitration. Critics

[189] Vandevelde, *Bilateral Investment Treaties* (n 114) 8.

[190] José Alvarez, 'Critical Theory and the North American Free Trade Agreements Chapter Eleven' (1997) 28 University of Miami Inter-American Law Review 303, 309; Todd Weiler, 'Balancing Human Rights and Investor Protection' (2004) 27 Boston College International and Comparative Law Review 429, 430.

imply that arbitrators, many of whom have professional backgrounds in commercial law, are unlikely to bring a balanced perspective to the resolution of disputes.[191] Although these debates do not directly relate to the level of substantive protection provided by IITs, they do show that the vast majority of scholars agree that IITs implicate competing interests and that, in the abstract, a balance between competing interests is normatively desirable.

Discussion of balance is also an important component of normative debate about the level of protection provided by IITs. Several scholars have argued that desirable interpretations of indirect expropriation and FET are those that balance investors' rights against states' legitimate regulatory prerogatives.[192] Other scholars use the concept of sustainable development, in its interstitial sense, as a normative criterion by which to evaluate the balance IIT protections strike between competing economic, environmental and social interests.[193] Sustainable development demands the reconciliation of competing primary norms, with special attention to environmental conservation and the effect that depletion of non-renewable resources would have on future generations.[194]

This section does not attempt to construct a theory of how tension between competing primary norms should be reconciled, or whether sustainable development should be the guiding principle in the balancing of competing norms. There is clearly room for disagreement about the appropriate balance that should be struck between competing

[191] Tienhaara (n 154) 206; cf Paulsson (n 125) 1.

[192] Benedict Kingsbury and Stephan Schill, 'Public Law Concepts to Balance Investors' Rights with State Regulatory Actions in the Public Interest - the Concept of Proportionality' in Stephan Schill (ed), *International Investment Law and Comparative Public Law* (Oxford University Press 2010) 103.

[193] Roland Klager, ''Fair and Equitable Treatment' and Sustainable Development' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 249.

[194] Riccardo Pavoni, 'Environmental Rights, Sustainable Development, and Investor-State Case Law' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 556.

incommensurable interests. It seeks only to make a simpler point: that any meaningful discussion of what balance, sustainable development or good judgement requires depends on prior specification of the primary norms that need to be balanced.

2.7 Synthesis of normative debate, as it relates to IIT protections

The analysis in previous sections entails a number of important conclusions for this thesis. The first of these is that much normative debate about IITs relies on *methodologies* that are not appropriate for the prospective evaluation of different levels of protection. Critiques of IITs based on historical methodology are relevant to debates about whether the existence of IITs is desirable, but do not provide much guidance on the level of protection that should be provided, given that such treaties exist. Critiques based on comparative methodology focus primarily on debates about whether investor-state arbitration is an appropriate institution for determining states' liability for the exercise of public powers. Comparative methodology is only capable of justifying normative conclusions about the level of protection provided by IITs insofar as it incorporates a set of normative premises about the desirable degree of legal protection of private investment from losses caused by the state.

The second conclusion that can be drawn from the analysis is that some norms invoked in debates about IITs are not coherent *criteria* by which to evaluate the merit of adopting a given level of protection. The criteria of sovereignty and consent fall into this class. Criticism that an IIT protection constitutes too great an interference with states' sovereignty requires recourse to some further normative framework to determine how much interference with sovereignty can be justified. Justification of existing IIT protections on the basis that states have consented to them does not provide grounds for prospective evaluation of different levels of protection. Moreover, reference to a treaty's purpose is not sufficient grounds for normative judgement. Justification of an IIT protection on the grounds that it

advances a treaty's purpose requires reference to some further normative framework to confirm that the purpose is a desirable one, and that pursuit of the treaty's purpose does not come at the expense of unjustifiable harm to other interests. Similarly, the desirable degree of deference to decisions taken in the political sphere of host states depends on specification of primary norms implicated by the decision and the decision-making process.

A third conclusion concerns the identification of norms invoked in existing debate about IITs that are capable of justifying a preference between different levels of protection. These norms include:

1. The claim that increases in FDI flows and economic efficiency are desirable.
2. The claim that respect for the rule of law in the legal systems of signatory states – in the Razian sense of norms relating to the procedural and formal characteristics of law and legal systems – is desirable.
3. The claim that the conservation of environmental resources is desirable.
4. The claim that the realisation of human rights is desirable.
5. The claim that protection of property rights is intrinsically desirable. The basis for the intrinsic value of property rights is not articulated in the IIT literature, but it presumably depends on a theory of distributive justice, most likely libertarian theory.
6. The claim that sustainable development is desirable. In its portmanteau sense, sustainable development functions as an umbrella term for a set of other primary norms, including environmental conservation, realisation of human rights, distributive justice and economic efficiency. Thus, it does not appear to add anything to the five norms articulated above.
7. The claim that good governance is desirable. Recent justifications for IIT protections invoke the concepts of good governance and the rule of law (understood in a broader sense than Razian norms). While focusing attention on the effects of IIT protections

> on the exercise of government power, these umbrella concepts do not appear to expand the criteria by which these effects should be evaluated beyond the five primary norms articulated above.

These norms form the basis of the normative framework developed in Chapter 4.

A fourth conclusion that emerges from this chapter's review of normative scholarship is that there is remarkably little dispute that the norms articulated in the previous paragraph are desirable. Few advocates of greater protection for foreign investors disagree that the realisation of human rights or the protection of the environment are normatively desirable. Even critics who doubt whether greater FDI flows and improvements in economic efficiency are worth their perceived environmental and social costs do not dispute that the latter objectives are desirable, all other things being equal. Normative disagreement stems partly from disagreement about which norms should be prioritised and how tension between competing norms should be reconciled.

A fifth conclusion is that most normative debate about IIT protections is already framed in explicitly consequentialist terms. Arguments that IIT protections increase FDI flows, improve economic efficiency, discourage governments taking measures necessary for environmental conservation, reduce the realisation of human rights or encourage good governance in signatory states are all arguments that rest on causal assumptions. Sometimes the causal assumptions underpinning these arguments are made explicit; often they are left unarticulated. Evaluating the strength of these arguments requires examination of the theoretical coherence of the underlying causal assumptions as well as empirical investigation of whether the effects of IIT protections are, indeed, those assumed.

Chapter 3 Methodology

3.1 Introduction

This chapter draws on the insights of the previous chapter to develop the methodology used in this thesis. The chapter begins, in Section 3.2, by arguing normative evaluation of IIT protections should be built on the understanding that these protections are liability rules – rules that require states to compensate foreign investors for certain classes of loss. This section also explains the significance of characterising IIT protections as liability rules. Section 3.3 then introduces the methodology employed in this thesis – consequential evaluation. Consequential evaluation involves the prospective assessment of levels of protection on the basis of their likely consequences, with the consequences evaluated according to specified normative criteria. This section justifies the choice of methodology and explains how the methodology is operationalised in this thesis. Section 3.4 situates the methodology relative to established methodologies in legal scholarship.

3.2 Reframing debate: IIT protections as liability rules

This thesis contends that normative debate should be framed by the understanding that IIT protections are liability rules – rules that require states to compensate foreign investors for losses caused by conduct that breaches those protections.[195] The concept of liability rules, as contrasted with property rules and inalienability, derives from an article by Calabresi and Melamed. Liability rules, property rules and inalienability describe three different ways in which a given legal entitlement might be protected. These three different forms of protection are distinguished by their associated remedies. An entitlement is protected by a liability rule

[195] Van Aaken and Montt have also argued that investors' entitlements under IITs are currently protected by liability rules, Anne van Aaken, 'Primary and Secondary Remedies in International Investment Law and National State Liability' in Stephan Schill (ed), *International Investment Law and Comparative Public Law* (Oxford University Press 2010) 722, 746; Montt (n 23) 6.

if the individual that holds the entitlement is unable, *ex ante*, to prevent another actor from interfering with the entitlement but is capable of recovering compensatory damages for interference *ex post*.[196] To be clear, an entitlement protected by a liability rule still entails a corresponding legal obligation on the duty-bearer not to interfere with the entitlement.[197]

Provisions in IITs that require compensation for expropriation (including indirect expropriation) are clearly liability rules.[198] The wording of expropriation provisions is permissive – it allows a state to expropriate foreign investors' property on payment of compensation, provided that basic legality requirements are satisfied.[199] FET provisions in IITs are not phrased in permissive language. They purport to oblige states to provide foreign investors with a certain standard of treatment. Nevertheless, the identifying characteristic of a liability rule is its associated remedy, not the way in which the obligation is phrased. In investor-state disputes, the normal remedy for breach of the FET standard is compensation.[200] For this reason, FET provisions should be understood as liability rules.

Tribunals adjudicating investor-state disputes under IITs do have the inherent authority to award non-pecuniary remedies – such as, injunctions and orders of specific performance – unless this authority is expressly excluded by the IIT in question.[201] Both injunctions and specific performance are remedies that purport to constrain the manner in

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[196] Guido Calabresi and A. Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability' (1972) 85 Harvard Law Review 1089, 1092.

[197] ibid 1116.

[198] ibid, 1106.

[199] Generally, that the expropriation is for a public purpose; non-discriminatory; and complies with due process.

[200] Dolzer and Schreuer (n 64) 271; Schill, *The Multilateralization of International Investment Law* (n 26) 250.

[201] Christoph Schreuer, 'Non-Pecuniary Remedies in ICSID Arbitration' (2004) 20 Arbitration International 325, 329; Martin Endicott, 'Remedies in Investor-State Arbitration' in Philippe Kahn and Thomas Wälde (eds), *New Aspects of International Investment Law* (Martinus Nijhoff Publishers 2007) 550. The authority to award a non-pecuniary remedy is excluded by NAFTA and partially excluded by the ECT, NAFTA (n 9) art 1135; ECT (n 10) art 26(8).

which a government may exercise is powers. That tribunals have authority, in theory, to award these remedies might raise doubts about the characterisation of FET provisions as liability rules. However, non-pecuniary remedies cannot be enforced under the ICSID Convention and, while their enforceability is not specifically excluded by the New York Convention, there is no obvious mechanism by which a successful investor could enforce an injunction in an UNCITRAL award.[202]

The difficulty of enforcing non-pecuniary remedies, coupled with tribunals' respect for the sovereign prerogatives of states, explains why the overwhelming majority of arbitral decisions award only damages for breach of the FET standard.[203] Indeed, the literature cites only one case in which an IIT tribunal has awarded a non-pecuniary remedy against a state (excluding declarations that a treaty has been breached).[204] In that case, *Goetz v Burundi*, the Tribunal offered the host state a choice between paying compensation to the investor and revoking the measure that breached the treaty. As the decision allowed the host state the option to maintain its chosen measure and pay compensation, it is consistent with understanding the FET standard as a liability rule.[205] A second, more recent decision, *ATA v*

[202] ICSID Convention (n 8) art 54(1); New York Convention (n 8) art III.

[203] Sigvard Jarvin, 'Non-Pecuniary Remedies' in Arthur Rovine (ed), *Contemporary Issues in International Arbitration and Mediation* (Martinus Nijhoff 2008) 183; Kaj Hobér, 'Remedies in Investment Disputes' in Andrea Bjorklund, Ian Laird and Sergey Ripinsky (eds), *Investment Treaty Law: Current Issues III* (British Institute of International and Comparative Law 2009) 13.

[204] Schreuer (n 201) 329; Jarvin (n203) 172; Hobér (n203) 13; *Enron Corporation v Argentine Republic* ICSID Case No ARB/01/3, Decision on Jurisdiction, 14 January 2007 [80]. The Tribunal in *Occidental* did hold that the Ecuadorian tax authority's rulings demanding payment from the claimant were 'without legal effect', *Occidental Exploration and Production Company v the Republic of Ecuador* LCIA Case No UN3467, Final Award, 1 July 2004 [202]. However, this declaration was made in a section of the award headed 'compensation due', and was part of the Tribunal's attempt to make a net pecuniary award settling the financial claims and counter-claims between the claimant and the respondent. Reviewing the decision, the English High Court interpreted the Tribunal's statement as a declaration that the tax rulings had breached the applicable treaty, rather than as an attempt to grant a remedy invalidating the tax rulings as a matter of Ecuadorian law, *Republic of Ecuador v Occidental Exploration and Production Co* [2006] EWHC (Comm) 345 124.

[205] 'Le choix relève de la décision souveraine du Gouvernement burundais.' *Goetz v Burundi* ICSID Case No ARB/95/3, Award (Embodying the Parties Settlement Agreement), 10 February 1999 [133].

Jordan, also resulted in the award of a non-pecuniary remedy. The tribunal ordered that the respondent restore the claimant's right to arbitration of disputes under a contract, which had been extinguished by legislation.[206] However, in this case it was the respondent state itself that had proposed non-pecuniary remedy.[207] This award is also consistent with the understanding of the FET standard as a liability rule; it appears the host state could have refused to restore the right to arbitration of contractual disputes and chosen, instead, to pay compensation.

One difficulty with characterising indirect expropriation and FET as liability rules is that some IITs allow these protections to be enforced through state-state arbitration. Tribunals resolving state-state disputes may be more inclined to award non-pecuniary remedies than those hearing investor-disputes. Notwithstanding this possibility, this thesis is justified in ignoring state-to-state dispute settlement – and its associated remedies – because the procedure does not play a significant role in enforcing the protections of IITs. Many hundreds of cases have been brought under their investor-state dispute settlement procedures. There are only three publicly known occasions in which the state-to-state dispute settlement procedures have been invoked under an IIT. (It is possible that state-state dispute settlement procedures have been used in other IIT disputes that have not become public). The first is a case brought by Peru against Chile in response to an investor-state proceeding that a Chilean investor had brought against Peru. The state-to-state dispute was subsequently discontinued,[208] while the associated investor-state dispute proceeded to a final decision.[209] The second is a claim

[206] *ATA Construction and Trading Company v The Hashemite Kingdom of* Jordan ICSID Case No ARB/08/2, Award, 18 May 2010 [127]-[132].

[207] ibid [131].

[208] UNCTAD, 'Latest Developments in Investor-State Dispute Settlement' [2005] International Investment Agreements Monitor 2.

[209] *Lucchetti v Peru* ICSID Case No ARB/03/4, Award, 7 February 2005.

brought by Italy against Cuba under the BIT between those states. In this case the Tribunal found that Cuba had not breached the BIT, so the issue of remedies did not arise.[210] The third is a recent claim initiated by Ecuador against the US. This dispute is yet to be heard by an arbitral tribunal.[211] In summary, no publicly known state-to-state dispute has resulted in the award of a non-pecuniary remedy. For this reason, the existence of state-to-state dispute settlement procedures under some IITs does not invalidate the characterisation of IIT protections as liability rules.

Characterising IIT protections as liability rules can clarify a number of issues in normative debate. For example, good governance justifications for IIT protections concern the impact of IITs on the exercise of public powers. As the normal remedies for breach of IIT protections do not directly constrain a state's ability to exercise public power, these normative concerns are best elaborated through examination of the way that the risk of liability under IITs affects governments' exercise of public powers.

3.3 The methodology of consequential evaluation

This thesis attempts to answer the question: of the alternative levels of investment protection implied by different interpretations of the FET and indirect expropriation provisions of IITs, which, if adopted, would be most desirable? It does not seek to determine the correct interpretation of FET and indirect expropriation provisions on doctrinal grounds. The methodology of this thesis involves the prospective assessment of alternative levels of protection on the basis of their likely consequences, evaluated according to a set of specified

[210] Jarrod Hepburn and Luke Eric Peterson 'Cuba prevails in rare state-to-state investment treaty arbitration initiated by Italy on behalf of Italian nationals' (2011) IA Reporter <http://ezproxy.ouls.ox.ac.uk:4998/articles/20110704_3> accessed 11 January 2012

[211] Luke Eric Peterson 'Ecuador initiates unusual state-to-state arbitration against United States in bid to clarify scope of investment treaty obligation' (2011) IA Reporter <http://ezproxy.ouls.ox.ac.uk:4998/articles/20110704_4> accessed 11 January 2012

normative criteria. This methodology is not unique in legal scholarship.[212] However, this section attempts to be more explicit about the structure of and justifications for consequential evaluation as a methodology by drawing on Amartya Sen's theoretical work. To be clear, reference to Sen's work is limited to his discussion of consequential evaluation as a methodology.

3.3.1 The basic features of consequential evaluation

3.3.1.1 Examination of consequences

The foundational premise of consequential evaluation is that normative scholarship should be based on evaluation of the likely consequences of options under consideration – in this thesis, given levels of IIT protections. There is no *a priori* limit to the type of consequences that might be included within consequential evaluation.[213] Sen argues that the consequences of any decision should be understood as including its effect on individuals' freedoms and capabilities as well as its effect on wealth distribution and preference-satisfaction.[214] In this respect, consequential evaluation differs from other forms of consequentialism that focus on a single metric of final outcome: for example, utilitarianism, which focuses exclusively on desire fulfilment; and narrow versions of welfare economics, which examine diverse benefits and costs only to the extent that they can be reduced to dollar values.

As a consequence-based methodology for normative judgement, consequential evaluation contrasts with deontological approaches to normative argument. The debate between proponents of various forms of consequential and deontological evaluation is complex and goes far beyond the scope of this thesis. Nevertheless, without seeking to

[212] See, Been and Beauvais (n 154) 87; Calabresi and Klevorick (n 28) 626.

[213] Amartya Sen, 'Consequential Evaluation and Practical Reason' (n 44) 484.

[214] ibid 493.

resolve the debate, it is worth noting that its inclusive approach to the identification of consequences allows consequential evaluation to address many of the deontological arguments traditionally raised by opponents of consequentialism.[215] Deontological theories are premised on the existence of ethical duties to respect certain rights (in the normative, not the doctrinal sense of the word) of other individuals. Consequential evaluation accommodates these concerns by directing a decision maker to assess the impact of a choice on both the negative and positive aspects of individuals' rights and freedoms. Consequential evaluation can distinguish between one option that violates a person's rights (because the person is tortured, for example) in achieving a given outcome and an alternative that achieves the same outcome without any person's rights being violated. At the same time, consequential evaluation provides a useful way of thinking about choices where different rights of different individuals are in tension with one another.[216]

3.3.1.2 Incommensurability and maximisation

One of the foundational premises of Sen's work on consequential evaluation is the incommensurability of consequences. Incommensurability, in this sense, is a rejection of attempts to quantify and weigh all consequences against each other within a single metric. Incommensurability is above all an empirical claim. An individual's ability to access an impartial court system, her job - which she finds rewarding - and the fresh apples in her pantry are all qualitatively distinct, even if they are all things which she values.[217]

Recognising incommensurability is also a response to epistemological problems with plausible bases for commensurability. Even if one wished to evaluate different consequences

[215] Siddiq Osmani, 'The Sen System of Social Evaluation' in K. Basu and R. Kanbur (eds), *Arguments for a Better World: Essays in Honor of Amartya Sen - Volume I* (Oxford University Press 2008) 24

[216] Sen, 'Consequential Evaluation and Practical Reason' (n 44) 499.

[217] Similarly, Amartya Sen, 'Incompleteness and Reasoned Choice' (2004) 140 Synthese 43, 44.

within a single metric, there is no non-arbitrary means by which different consequences could be quantified and weighed against each other. Using utility as a common unit of account is problematic because there is no way of quantifying the subjective experience of different individuals within a common metric.[218] An alternative is to use dollar values as a common unit of account, and examine individuals' willingness to pay for incommensurable benefits as a mechanism to derive dollar values for them. This approach is also flawed. It cannot be assumed that individuals' willingness to pay for public good provision is independent of what other individuals would consent to pay and of the process by which payment would be collected and allocated.[219] Yet, these assumptions underpin the ability of willingness to pay to generate determinate, transitive weightings.

The basic principle underpinning the evaluation of incommensurable consequences is maximisation: that desirable consequences should be maximised (and undesirable ones minimised) so far as is possible.[220] To pose a simple example, if one alternative is at least as good as the competing alternatives on every criteria and superior on at least one criterion it is the normatively best choice. More difficult issues arise when evaluation of alternatives requires a trade-off between different types of desirable consequences. The relationship between an overall assessment of net economic benefits and a normative evaluation of the distribution of economic costs and benefits raises specific issues of aggregation, rather than fundamental questions of incommensurability. These issues are taken up in section 4.4.3.1.

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[218] Lionel Robbins, 'Robertson on Utility and Scope' (1953) 20 Economica 99, 109. On the possibility of qualitiative, partial interpersonal utility comparisons see John Harsanyi, 'Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility' (1955) 63 The Journal of Political Economy 309, 309; Amartya Sen, 'Interpersonal Aggregation and Partial Comparability' (1970) 38 Econometrica 393, 407.

[219] Amartya Sen, 'The Discipline of Cost-Benefit Analysis' (2000) 29 Journal of Legal Studies 931, 946; Amartya Sen, *Rationality and Freedom* (Harvard University Press 2004) 536

[220] Maximisation should be contrasted with optimisation: the search for an ideal or 'optimal' approach given a defined set of constraints. Discussed in Amartya Sen, 'Maximization and the Act of Choice' (1997) 65 Econometrica 745, 772

3.3.1.3 Reasoning, social choice and consequential evaluation

Incommensurability implies that the process of evaluating the trade-offs inherent in a decision cannot be collapsed into the measurement of consequences itself. Judgements about the appropriate reconciliation of competing values can only be made after the consequences of a decision are identified. This raises the question of how the process of evaluation of identified consequences should occur. Sen's answer is that evaluation should occur through a process of qualitative reasoning. The necessity of *qualitative* reasoning in the evaluative process follows from the postulate of incommensurability of consequences. Although Sen does place some constraints on the process of evaluation,[221] qualitative reasoning permits a plurality of views about what is reasonable and, accordingly, a range of disagreement on the merits of a given choice.[222]

3.3.1.4 Evaluation of concrete alternatives

The comparison of specified, concrete alternatives, as opposed to the description of 'ideal' options, is a defining feature of consequential evaluation. Historically, this is due to the roots of consequential evaluation in the economics of social choice theory. At a conceptual level, it is impossible to use consequential evaluation to deduce ideal options because, in the absence of defined weightings for different consequences, there is no mechanism to determine the balance of characteristics that would define an ideal choice. Instead, consequential evaluation is a methodology for examination of a set of concrete alternatives. An additional advantage of the focus on clearly defined options is that it makes it easier to infer the consequences of the alternatives.

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[221] Amartya Sen, *The Idea of Justice* (Allen Lane 2009) 45, 197.

[222] ibid 206, 242.

3.3.2 Why consequential evaluation?

In my view, consequential evaluation is a useful methodology for normative evaluation of many different social choices. There are additional reasons why it is particularly well suited to evaluating the desirability of differing levels of IIT protection. First, existing normative debate about IIT protections is already framed primarily in consequential terms. The most coherent justifications for IIT protections are that they promote FDI, increase economic efficiency and, to a lesser extent, that they improve government decision-making in host states. If one wishes to take these arguments in favour of investor protection seriously, consequential reasoning is essential. The majority of criticisms of IIT protections are also framed in consequentialist terms. For example, the human rights critique of IIT protections is that they impede the realisation of human rights. To the extent that deontological arguments are present in existing normative debate, they can usefully be reframed in consequential terms. Given that IIT protections should be understood as liability rules, libertarian arguments can be assessed by asking whether IIT protections have a set of distributive consequences that is consistent with the requirements of libertarian theories of distributive justice.

Secondly, as one of a number of methodologies that focuses on consequences, consequential evaluation is specifically suited to the task at hand. Chapter 2 argued that current normative debates about IIT protections do not turn on disagreement about which objectives are desirable. Normative disagreement is largely due to different causal assumptions about the likely consequences of IITs and different views about the relative priority of competing objectives. Consequential evaluation is a way for these competing normative concerns to be brought within a single framework. Analysis of the extent to which prospective options are likely to lead to the desired outcomes enables consequential evaluation to go beyond a cataloguing of competing normative concerns.

Thirdly, explicitly acknowledging the incommensurability of consequences is particularly appropriate in the evaluation of different levels of IIT protection for three further reasons. First, alternative levels of protection engender a broad range of consequences, not simply economic costs and benefits. Second, these consequences are felt by different classes of individuals across a wide range of countries. As such, it is not clear whose willingness to pay should define the valuation function that would be required if consequences were to be weighed within a single metric.[223] Third, even if it were possible to identify all those potentially affected by IIT protections, there would be enormous practical difficulties in collecting data necessary to determine willingness-to-pay weightings.

3.3.3 Operationalising consequential evaluation

To the extent that Sen's writings provide guidance on how to apply a consequential evaluation, it appears that he envisages a two stage structure.[224] In the first, the likely consequences of the available choices are inferred with as much detail and accuracy as possible. In the second stage, the predicted consequences are evaluated through a process of reasoning. It is through this process of reasoning that normative premises are articulated and that the inferred consequences of the available options are evaluated by the articulated normative criteria. If this is an accurate characterisation of Sen's views, then this thesis departs from them. This thesis proposes a three stage structure to operationalise the methodology of consequential evaluation, a structure that reflects the specific challenges of evaluating different levels of IIT protection.

The first stage is the development of a normative framework. Chapter 4 of this thesis carries out this stage of analysis, which performs three distinct functions in operationalising

[223] Jeffrey Dunoff and Joel Trachtman, 'Economic Analysis of International Law' (1999) 24 Yale Journal of International Law 1, 47.

[224] Sen, 'Consequential Evaluation and Practical Reason' (n 44) 491.

the methodology consequential evaluation. This first function is to frame empirical enquiry into the likely consequences of adopting different levels of IIT protection. This analytical framing is necessary to make sense of the diverse range of potential consequences of IIT protections. Chapter 4 draws heavily on the review and critique of the existing normative scholarship in Chapter 2 to provide a framework within which the likely consequences of the adoption of various levels of protection can be categorised and understood. The second function of the normative framework is to articulate normative criteria by which the inferred consequences should be evaluated. This function is closely related to the normative framework's first function; indeed, in most cases, identified consequences are accepted as normatively valuable in themselves. However, there are consequences that require specification of further normative premises for evaluation; for example, evaluation of the effect of IIT protections on the distribution of economic costs and benefits requires the articulation of normative premises about distributive justice. The third function of the normative framework is to provide a review, assessment and synthesis of existing empirical evidence and explanatory theory that provides the basis for inferences about the likely consequences of IIT protections.

The second stage of analysis is the characterisation of the set of options – the different levels of protection that might be adopted. In this thesis, these options are derived from different understanding of the extent of protection provided by existing IIT provisions that have been articulated in existing jurisprudence. Chapter 5 defines alternative interpretations of the FET standard and Chapter 6 defines alternative interpretations of indirect expropriation. Each interpretation is sketched as model level of protection that might be adopted in the future.

The third stage of analysis is the application of the normative framework to evaluate the options defined in the second stage of analysis. The third stage of analysis is performed in

Chapter 7. It involves a comparison of the likely consequences of each level of protection if it were adopted. This stage of analysis relies on the normative framework developed in Chapter 4, both as the basis for inferences about the likely consequences of alternative levels of protection, and for specification of the normative criteria by which these consequences should be evaluated. In this way, Chapter 7 offers an answer to the question: of the differing levels of investment protection implied by different interpretations of the FET and indirect expropriation provisions of IITs, which, if adopted, would be most desirable?

3.4 The relationship between consequential evaluation and other methodologies used in legal scholarship

3.4.1 The use of methodologies similar to consequential in scholarship on IITs

The style of reasoning required by consequential evaluation should be familiar to legal scholars. Legal problems regularly raise questions that require the balancing of incommensurable ends.[225] A number of legal scholars have used similar methodologies to consequential evaluation without articulating them in those terms. In scholarship on IITs, the most coherent attempt to use such a methodology is Part IV of Been and Beauvais' seminal article *The Global Fifth Amendment?*[226] In this part of their article, they identify four policy rationales that could potentially justify a legal rule requiring states to compensate foreign investors for regulatory expropriation.[227] They argue that none of these rationales justifies compensation for regulatory expropriation.

This thesis goes beyond Been and Beauvais' methodology in a number of respects. First, the examination of the likely consequences of investment treaty protections in Chapter

[225] Anthony Kronman, *The Lost Lawyer* (Belknap Press 1993) 57.

[226] Been and Beauvais (n 154) 87.

[227] This analysis develops Beauvais' earlier argument in Joel Beauvais, 'Regulatory Expropriations under NAFTA' (2002) 10 New York University Environmental Law Journal 245, 256,

4 of this thesis is significantly more comprehensive than Been and Beauvais' discussion of the four cited rationales. Second, the subject matter of this thesis differs from their article. Been and Beauvais evaluated one treaty standard against the alternative of removing that standard from the treaty. This thesis evaluates a number of different levels of protection against alternative levels of protection. Third, this thesis has the advantage of access to the arbitral decisions, academic writing and empirical research that have become available since 2003, which are important new sources of information. These differences between the two projects aside, Been and Beauvais' article is this thesis' point of departure from the existing literature.

Part VI of Stiglitz's article *Regulating Multinational Corporations* also uses a methodology similar to that of this thesis.[228] Stiglitz asserts that:

> [A]n analysis of the desirability of extending to corporations certain rights is quintessentially a matter of economic and social analysis – to ascertain what are the consequences of one set of provisions or another.[229]

Within this framework he argues that arbitral panels' interpretation of the national treatment, expropriation and FET standards are neither economically efficient, nor socially equitable – being too favourable to investors on both criteria.[230]

Stiglitz's political and economic analysis is sophisticated and compelling, but he does not delve into the detail of the provisions he criticises. To be fair, he does not dwell on these questions because the normative conclusion of his article is that IITs should be totally redrafted with foreign investors entitled only to treatment according to national law, plus a post-establishment right to national treatment.[231] This thesis differs from Stiglitz work in that

[228] Stiglitz (n 62) 513.

[229] ibid 469.

[230] ibid 528.

[231] ibid 555.

it situates similar arguments within a clearer overall methodological framework, disaggregates 'social analysis' into a set of specified consequences and focuses on more nuanced questions relating to the desirable level of protection.

3.4.2 The contrast between consequential evaluation and law and economics methodologies

In identifying the likely consequences of adopting different levels of protection in IITs, this thesis shares an interest with the law and economics literature in the economic consequences of various legal rules. However, there are important differences between consequential evaluation and common law and economics methodologies. For the sake of clarity, it is worth noting the distinction between consequential evaluation and three different bodies of law and economics scholarship.

3.4.2.1 Chicago school of law and economics

The 'Chicago' approach to law and economics, particularly the work of Richard Posner, is an important methodological point of reference within the discipline of law and economics.[232] Chicago school law and economics uses neo-classical economic theory (as an explanatory theory) within a number of different methodologies. The Chicago methodology most relevant to this thesis is the normative use of economic theory to evaluate legal rules – a form of cost-benefit analysis based on the normative premise that legal rules should maximise Hicks-Kaldor efficiency.[233] Consequential evaluation rejects this premise. It accepts that other consequences – impacts on the distribution of resources, the realisation of human rights and process values, such as the rule of law – may have intrinsic normative value. It also recognises that these consequences are incommensurable and does not attempt to ascribe

[232] Nicholas Mercuro and Steven Medema, *Economics and the Law; From Posner to Post-Modernism and Beyond* (2nd edn, Princeton University Press 2006) 94.

[233] Richard Posner, 'Cost-Benefit Analysis' (2000) 29 Journal of Legal Studies 1153, 1154.

quantitative dollar values to them, which would allow them to be subsumed into the efficiency calculus.

3.4.2.2 The New Haven school of law and economics

Like scholars in the Chicago school, scholars within the New Haven tradition agree that economic efficiency is an important goal for legal rules and accept neo-classical economic theory as a rudimentary explanatory theory of human behaviour.[234] However, there are two important differences between the approaches. A hallmark of New Haven school of law and economics scholarship is the recognition that neo-classical theory does not provide a full account of human behaviour. Thus, many of the important contributions of New Haven scholars have focused on the implications of departures from neo-classical economic assumptions, for example: the implications of the fact that individuals may not have perfect information about the risks associated with their actions;[235] and the implications of the fact that there may be significant transaction costs associated with bargaining among individuals.[236] A second difference is in the set of normative premises it brings to bear. New Haven scholars do not accept that efficiency should be the only criterion by which legal rules are evaluated. This is clearest in Calabresi and Melamed's article, in which they suggest that the evaluation of a given legal rule could be divided into its evaluation on the grounds of 'efficiency', 'distribution' and 'other justice reasons' (a category that is left open and is potentially specific to the rule in question).[237]

The methodology of consequential evaluation has been profoundly influenced by the New Haven school of law and economics. The thesis follows Calabresi et al, both in the

[234] Mercuro and Medema (n 232) 285.

[235] Calabresi and Klevorick (n 28).

[236] Calabresi and Melamed (n 196) 1119.

[237] ibid 1102.

premise that efficiency is one, but not the only, normative criterion by which legal rules should be assessed and in the willingness to consider whether the simplifications of neo-classical economics are justified in the course of empirical inquiry into the consequences of a legal rule in terms of efficiency. The thesis also draws on more specific insights from the New Haven school of law and economics, specifically the characterisation of IIT protections as liability rules. Nevertheless, consequential evaluation goes beyond the work of New Haven scholars in important respects, both in attempting to articulate normative principles that might be used to evaluate the distributive effects of legal rules and, in the specific context of IITs, by trying to give content to 'other justice reasons'. This does not diminish the enormous intellectual debt I owe to the work done by New Haven scholars. Any misgivings about positioning consequential evaluation as a law and economics methodology within the New Haven school of law and economics stem from my reluctance to be associated with the view that economic efficiency is the *primary* criterion by which legal rules should be evaluated.

Finally, it is important distinguish the New Haven school of law and economics from the New Haven school of international law. Scholars such as McDougal, Lasswell and Reisman have argued that the interpretation of international legal rules should be understood as involving choice about the best way to achieve policy goals.[238] This thesis offers a prospective, normative evaluation of international legal rules that might be adopted in the future; it does not purport to provide a doctrinal theory concerning the 'correct' interpretation, or the 'correct' approach to interpretation, of existing legal rules. This thesis draws only on the work of New Haven law and economics scholars; it does not adopt or endorse the views of those associated with New Haven approaches to international law.

[238] Michael Reisman, 'The View from the New Haven School of International Law' (1992) 86 American Society of International Law Proceedings 118, 120.

3.4.2.3 International law and economics

It remains to distinguish consequential evaluation from the methodologies used in law and economics scholarship relating to international law. There is an emerging literature that attempts to apply methodologies derived from law and economics to international law.[239] Within this literature the majority of contributions deploy economic theory as behavioural theory to explain the way in which states interact with other states.[240] A particular focus is to explain the circumstances in which it will be in states self-interest to subject themselves to enforceable legal rules on the international plane.[241] In two recent publications van Aaken applies this methodology to states' decisions to sign IITs, concluding that overly strict interpretation of IIT protections may encourage states to withdraw from these treaties.[242] Insights from this research are potentially relevant to this thesis so far as they concern states' likely response to the adoption of various legal rules. However, the focus of this research is very different in that it addresses the question empirical questions about why states agree to legal rules, rather than normative questions about the legal rules that states should agree to.

3.5 Conclusion

This chapter has argued that different levels of IIT protection should be evaluated using the methodology of consequential evaluation – assessment on the basis of their likely consequences, with those consequences evaluated according to specified normative criteria. It

[239] Dunoff and Trachtman (n 223) 2.

[240] Alan Sykes, 'International Law' in M. Polinsky and S. Shavell (eds), *Handbook of Law and Economics* (North-Holland 2007) 762.

[241] For example, the debate between Eric Posner and John Yoo, 'Judicial Independence in International Tribunals' (2005) 93 California Law Review 1; and Laurence Helfer and Anne-Marie Slaughter, 'Why States Create International Tribunals' (2005) 93 California Law Review 899. See also Robert Scott and Paul Stephan, *The Limits of Leviathan* (Cambridge University Press 2006).

[242] Anne van Aaken, 'International Investment Law between Commitment and Flexibility' (2009) 12 Journal of International Economic Law 507, 537; Anne van Aaken, 'The International Investment Protection Regime through the Lens of Economic Theory' in Michael Waibel and others (eds), *The Backlash against Investment Arbitration* (Kluwer Law International 2010) 554.

justified this choice of methodology and explained how the methodology is operationalised in this thesis. In operationalising the methodology of consequential evaluation, the first challenge is to develop a framework for inferring the likely consequences of different levels of IIT protection. It is to this task the thesis now turns.

Chapter 4 A Normative Framework for Evaluating Different Levels of IIT Protection

4.1 Introduction

The purpose of this chapter is to construct a framework that provides a basis for evaluating different levels of IIT protection. Chapter 3 argued that IIT protections should be understood as liability rules and that a *normative* preference for a given level of protection to an alternative level of protection should be based on a comparison of the likely consequences of each level of protection, if it were adopted. Therefore, the framework must perform two tasks: it must provide an informed basis for drawing inferences about the likely consequences of adopting different levels of protection; and it must specify the normative criteria by which these consequences should be evaluated.

This chapter draws on the critique and synthesis of normative scholarship relating to IIT protections presented in Chapter 2 to propose a categorisation of the likely consequences of IIT protections that is as comprehensive as possible.[243] It argues that a prospective assessment of the consequences of adopting a given level of IIT protection can be divided into five categories, the effect on: efficiency; the distribution of economic costs and benefits; flows of FDI into host states; the realisation of human rights and environmental conservation in host states; and respect for the rule of law in host states. Within this framework, the chapter provides a synthesis of evidence and theory, on the basis of which conclusions about the likely consequences of differing levels of protection can be drawn.

From the outset, it is important to emphasise that this chapter does not attempt to provide a framework for determining the consequences of signing IITs, or of agreeing to the

[243] Text at p 59.

arbitration of investor-state disputes under IITs, or of adopting of policies or laws that promote foreign investment. Rather, the purpose of the framework is to provide a basis for addressing a specific, but nevertheless important, question of legal policy. Insofar as state have signed IITs that provide for the compulsory investor-state arbitration of disputes, the purpose of the framework is to provide a basis for inferring the likely consequences of providing differing levels of substantive protection in such treaties.

The purpose of the framework is also to specify the normative criteria by which the predicted consequences should be evaluated. In articulating these normative criteria, this chapter again takes the analysis of Chapter 2 as its point of departure. The chapter argues that most of the identified consequences are normatively desirable in themselves, specifically: economic efficiency, the realisation of human rights; environmental conservation; and respect for the rule of law. Consistently with the existing literature, the attraction of FDI is accepted as a proxy for other desirable consequences. This chapter recognises considerable disagreement about the normative criteria by which distributive impacts should be evaluated. Four independent normative criteria are proposed, against which alternative levels of protection should be evaluated.

This chapter comprises eight substantive sections. Section 4.2 explains and justifies the approach to theory and empirical evidence adopted in this chapter. Sections 4.3 to 4.7 constitute the normative framework, dealing respectively with the likely consequences of alternative levels of IIT protection for: efficiency; the distribution of economic costs and benefits; flows of FDI; the realisation of human rights and environmental conservation; and respect for the rule of law. Each section explains why the identified consequence should form part of the normative framework and examines how the consequence relates to the other identified consequences. Section 4.8 argues that other categories of consequences are unnecessary. In doing so, it justifies the claim that the normative framework provides an

account of the likely consequences of different levels of IIT protections that is as comprehensive as possible. Section 4.9 highlights some preliminary conclusions that emerge from the normative framework.

4.2 The approach to theory and evidence used to develop the normative framework

The normative framework developed in this chapter provides a basis for inferring the likely consequences of adopting alternative levels of IIT protection. The framework provides a basis for the *prospective* evaluation of alternatives that might be adopted in the future. As none of the options under consideration has ever been adopted, no direct evidence of their consequences is available.[244] Instead, inferences about the likely consequences of alternative levels of protection are drawn from explanatory theory and, to the extent that it is available, existing indirect empirical evidence on the consequences of IITs as they currently operate. This thesis adopts a particular approach to theory and evidence – one grounded in the tradition of the New Haven school of law and economics. This section explains and justifies the general approach to theory and evidence used in this chapter; it also acknowledges weaknesses of this approach and explains how these weaknesses are addressed. In addition, sections 4.3 to 4.7 commence with a consideration of specific issues in the relationship between theory and evidence as they relate to each category of consequence.

4.2.1 Justifications for engaging with explanatory theory

IITs apply to hundreds of states, potentially affecting investments made by many thousands of foreign investors. Given their range of application, one might reasonably ask if any inferences can sensibly be drawn as to the likely consequences of adopting alternative levels of substantive protection. There are three fundamental justifications for exploring inferences

[244] The evidential value of arbitral awards in which tribunals have interpreted and applied IIT protections is discussed in section 4.2.4.

that can be drawn from explanatory theories. The first is that it is difficult to make sense of empirical data without recourse – either implicit or explicit – to a theory of some sort.[245] For example, should empirical data showing that the ratification of a BIT correlate with increases in overall FDI but not with increases in FDI from the other signatory state be understood as evidence for or against the efficacy of BITs in attracting FDI?[246] Without invoking a theoretical model, however rudimentary, it is difficult to explain why empirical observations should be understood as evidence of causal connections between phenomena.

The second, related, justification for engagement with explanatory theory is the need to draw inferences about the likely consequences of legal rules at an appropriate level of abstraction.[247] While case studies of particular foreign investments or regulatory actions may yield specific insights, a normative preference for one level of investment protection requires inferences to be drawn at a higher level of generality.[248] Even if a causal connection between specific phenomena can be observed – for example, that one country experienced an increase in FDI as a result of signing an IIT – some theoretically informed process of abstraction is required, both: to determine whether this is evidence of a broader causal pattern, rather than an interesting but unimportant anomaly; and to interpret the significance of this observation about the consequences of *an existing IIT* for debate about the likely consequences of *different levels of protection* in future IITs.

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[245] Adrienne Hertier 'Causal Explanation' in Dontaella della Porta and Michael Keating (eds), *Approaches and Methodologies in the Social Sciences* (Cambridge University Press 2008) 70.

[246] This finding is reported in Kevin Gallagher and Melissa Birch, 'Do Investment Agreements Attract Investment? Evidence from Latin America' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 305. Commitment theory and signalling theory, both of which are discussed in section 4.5.4, imply different answers to this question.

[247] see Allan Gibbard and Hal Varian, 'Economic Models' (1978) 75 Journal of Philosophy 664, 675 arguing that the utility of causal models depends on the degree of abstraction required to address problem under consideration.

[248] Stokey and Zeckhauser (n 41) 8.

The third justification stems from the fact that, as argued in Chapter 2, a range of causal assumptions about the impact of IIT protections are already implicit in existing normative debate about IITs. This chapter seeks to make causal assumptions that are already embedded in existing debate explicit, examine whether they are theoretically coherent and test them against available evidence.

4.2.2 Law and economics and the approach to explanatory theory developed in this chapter

The approach to explanatory theory developed in this chapter draws on the discipline of law and economics. There are many different theoretical perspectives within the discipline of law and economics. However, the common foundation of the discipline is the assumption that individuals are influenced by incentives, tending to act in a way that minimises the costs and maximises the benefits of their actions.[249] Two of the most prominent exponents of the law and economics approach have gone so far as to argue that:

> [E]conomics provides a behavioral theory to predict how people respond to law. This theory, which is based on how people respond to incentives, surpasses intuition just as science surpasses common sense.[250]

This view is overly sanguine. It ignores criticism of the economic theory of behaviour from within and beyond the discipline of economics.[251] Assumptions about how individuals respond to incentives are assumptions about empirical questions that, in particular contexts, may or may not be true. The validity of predictions derived from theoretical models is

[249] Mitchell Polinsky and Steven Shavell, 'Economic Analysis of Law' in Steven Durlauf and Lawrence Blume (eds), *The New Palgrave Dictionary of Economics* (2nd edn Palgrave Macmillan 2008).

[250] Robert Cooter and Thomas Ulen, *Law & Economics* (5th edn, Pearson Addison-Wesley 2008) 4.

[251] eg Amartya Sen, 'Rational Fools: A Critique of the Behavioral Foundations of Economic Theory' (1977) 6 Philosophy and Public affairs 317; Julis Margolis, 'Comment on Niskanen "Bureaucrats and Politicians"' (1975) 18 Journal of Law and Economics 645.

contingent on the accuracy of the causal assumptions that underpin those models and the extent to which their predictions are confirmed by evidence.[252]

Nevertheless, there are two justifications for drawing on theory developed within the law and economics tradition in this chapter. The first is that law and economics provides a developed literature on the use of behavioural theories for predicting the consequences of legal rules.[253] Behavioural theories within the law and economics tradition have been considered in academic discussion of domestic legal rules governing tort and the protection of property,[254] as well as international legal rules governing international trade, public procurement and the protection of intellectual property.[255] This academic acceptance does not prove that the predictions derived from an economic theory of behaviour will necessarily prove to be correct. Rather, working within an existing analytical tradition, in which there is already a detailed literature on the strength and weaknesses of various behavioural models,[256] allows a more cautious and nuanced engagement with explanatory theory. The second

[252] Hertier (n 245) 63; cf Milton Friedman, *Essays in Positive Economics* (University of Chicago Press 1953) 43.

[253] Joel Trachtman, 'International Economic Law Research: a Taxonomy' in Colin Picker, Isabella Bunn and Douglas Arner (eds), *International Economic Law: The State and Future of the Discipline* (Hart 2008) 50:

> [L]aw and economics theory, based on an open system social consensus, seems to have greater claims to plausibility than more eclectic traditional legal scholarship. It is based on assumptions about human behaviour that have been tested in many other contexts and in which useful hypotheses have been derived. It forms a branch of a broader research program that has been subjected to greater scrutiny and discipline.

[254] Calabresi and Klevorick (n 28); Blume, Rubinfeld and Shapiro (n 67).

[255] Kyle Bagwell and Robert Staiger, 'An Economic Theory of GATT' (1999) 89 The American Economic Review 215; Peter Trepte, *Regulating Procurement: Understanding the Means and Ends of Public Procurement Regulation* (Oxford University Press 2004); Gene Grossman and Edwin Lai, 'International Protection of Intellectual Property' (2004) 94 American Economic Review 635.

[256] See, for example, academic contributions on the extent to which the basic behavioural model of economics should be modified to address the problems of: strategic behaviour, Robert Cooter, Stephen Marks and Robert Mnookin 'Bargaining in the Shadow of Law: a Testable Model of Strategic Behavior' (1982) 11 Journal of Legal Studies 225; risk aversion, Steven Shavell, *Economic Analysis of Accident Law* (Harvard University Press 1987) 186; imperfect information, George Stigler, 'The Economics of Information' (1961) 69 Journal of Political Economy 213; and bounded rationality, Herbert Simon, 'Rationality in Psychology and Economics' (1986) 59 Journal of Business 209.

justification is that consideration of the economic costs and benefits of legal rules is central to normative debate about IITs and IIT protections. Economic theory provides a theoretical toolkit for thinking systematically about the economic costs and benefits of adopting various legal rules.

4.2.3 The relationship between theory and empirical evidence – criticisms of the law and economics approach

A key reference point for this chapter's approach to economic theory is Calabresi's *The Costs of Accidents*. Until the 1960s academic debate about accident law – and the reform of accident law – focused on the policy goal of providing compensation to victims.[257] This focus is consistent with the experience of practising lawyers, who generally encounter the legal issues arising from accidents only once an accident has occurred. In *The Costs of Accidents*, Calabresi argued that normative debate about accident law should also consider the extent to which different regimes of accident law were likely to reduce the number and severity of accidents, reduce the costs of such accidents to society and minimise the costs of administering the regime of accident law.[258] Calabresi compared a range of alternative legal rules, using behavioural models based on economic theory to infer the likely consequences of adoption of each of the options under consideration.[259]

While highly influential, *The Costs of Accidents* was criticised by some reviewers for its inadequate engagement with empirical data. Englard criticised the empirical accuracy of the *behavioural assumptions* underpinning the economic model on which Calabresi relied. Calabresi had argued that a system imposing tort liability for the consequences of one's conduct would have a greater deterrent effect on accident-causing behaviour than a system in

[257] Bob Hepple, 'Book Reviews: *The Costs of Accidents*' (1970) 28 Cambridge Law Journal 350, 351

[258] Calabresi *The Costs of Accidents* (n 25) 26-28.

[259] ibid 69.

which accident victims were compensated from the public purse. Citing the hypothesis that accident-causing behaviour often entails the risk of self-injury or even death, Englard doubted whether the 'additional economic pressure' of liability would have any influence on the behaviour of individuals.[260] In contrast, Posner criticised Calabresi for failing to consider whether the *predictions* he derived from his economic model of behaviour were supported by evidence drawn from the experience of different jurisdictions that had adopted different systems of accident law.[261] Both criticisms are important and well made; they are iterations of wider critiques that might be made of any attempt to infer the consequences of legal rules from economic theories of behaviour, including the law and economic approach utilised in this chapter.

This chapter addresses the weaknesses related to the potential inaccuracy of *assumptions* in three ways. The first way is by making assumptions explicit. Making assumptions explicit does not prove that they are correct; rather, it focuses empirical debate by drawing attention to the empirical basis on which theoretical predictions depend. For example, this chapter shows that the assumption that states are more likely to be dissuaded from adopting measures that entail liability than from adopting measures that do not entail liability, is a key assumption underpinning the arguments of both the critics and defenders of IITs in relation to regulatory chill.[262]

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[260] Izhak Englard, 'The System Builders: a Critical Appraisal of Modern American Tort Theory' (1980) 9 Journal of Legal Studies 27, 45.

[261] Richard Posner 'Reviews: *The Costs of Accidents*' (1970) 37 University of Chicago Law Review 636, 647.

[262] Kyla Tienhaara, 'Regulatory chill and the threat of arbitration: a view from political science' in Chester Brown and Kate Miles (eds), Evolution in Investment Treaty Law and Arbitration (Cambridge University Press 2011) 626; Stephan Schill, 'Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?' (2007) 24 Journal of International Arbitration 469, 477; Vandevelde, *Bilateral Investment Treaties* (n 114) 107.

The second way of addressing the potential inaccuracy of assumptions is to test the assumption against existing evidence. For example, examination of cases in which states have withdrawn measures in response to investor challenge provides qualified support for the assumption that, all things being equal, states are less likely to maintain measures that entail liability to investors.[263] This is the most direct way of confronting the assumptions critique; however, it relies on the availability of evidence that sheds light on the accuracy of underlying assumptions. Relevant evidence may not be available and evidence that is available may be incomplete or indeterminate. The third way of addressing the potential inaccuracy of assumptions is by considering whether the analysis would be altered if an assumption proved to be incorrect. For example, this chapter argues that foreign investors are likely to be risk neutral.[264] However, it goes on to show that the conclusions derived from the assumption of risk neutrality would not be significantly altered if it turned out that, in fact, investors were risk averse.[265] This structure of argument – reflecting on whether predictions derived from causal models are robust to variations in the underlying assumptions – is central to social scientific scholarship.[266]

The critique of *predictions* raises more complex issues. As none of the options under consideration has ever been adopted, no direct evidence of their consequences is available. As such, it is not possible to test the inferences drawn from explanatory theory in this chapter against direct evidence. That said, Posner's critique of *The Costs of Accidents* was not that it was inappropriate to draw inferences about the likely consequences of legal rules from theoretical models. The critique was that such an exercise was diminished by its failure to

[263] see section 4.6.4.3.

[264] see text from n 309.

[265] see section 4.3.5.4.

[266] Gibbard and Varian (n 247) 675.

consider evidence from situations in which such rules had been adopted, *to the extent such situations existed*.

This chapter addresses the *predictions* critique by integrating evidence that is indirectly relevant to the assessment of likely consequences of alternative levels of protection into the overall analysis, to the extent that such evidence is available. For example, the discussion of the likely effect of alternative levels of protection on FDI flows is primarily derived from an examination of empirical data on the distinct but related issue of the extent to which the signing of BITs increases FDI.[267] In that section, theory is only considered so far as reference to some causal model is necessary to interpret the empirical evidence; and, given that a review of the evidence shows it to be indeterminate, to consider the implications that would follow if future empirical evidence did show a relationship between IITs and FDI. In sections where relevant evidence is limited – such as the assessment of the likely net costs and benefits of alternative levels of protections – the analysis is theoretically driven. Because predictions derived from this analysis are difficult to verify, greater attention is paid to: the empirical validity of the underpinning assumptions; the internal coherence of theoretical arguments; issues raised by counter-arguments in the existing literature; and the extent to which general predictions may obscure important causal effects that arise in particular circumstances.

4.2.4 To what extent do the decisions of arbitral tribunals constitute evidence?

The framework developed in this chapter provides a basis for the *prospective* evaluation of alternatives that might be adopted in the future. While the alternative levels of protection evaluated in this thesis are derived from the awards of arbitral tribunals in past cases, these decisions do not constitute *direct* evidence of the consequences of providing a particular level

[267] see section 4.5.3.

of protection through IITs. This is because the investment decisions of the investor and the regulatory decisions of the host state were made prior to the tribunal interpreting the applicable IIT provision as entailing a particular level of protection. This is a distinct situation to that posited in this thesis, which seeks to evaluate different levels of protection that might be adopted in IITs in the future. This thesis considers the likely consequences of adopting given levels of protection, specified with much greater precision than is currently provided by IITs. As such, the thesis considers (hypothetical, future) situations in which there is greater certainty as to the level of protection provided by IITs at the time when relevant investment and regulatory decisions are made.

The strength of existing decisions as an *indirect* evidentiary source is that they provide a highly detailed factual record, each of which serves as a case study of the issues to which IITs apply.[268] Evidence derived from decided cases is most useful 'to test hypotheses ... about the behaviour of legal institutions', rather than hypotheses 'about the social effects of law'.[269] This thesis is primarily concerned with hypotheses about the likely social effects of law. The factual record of existing cases can, however, provide *indirect* evidence that may be relevant in testing hypotheses about the social effects of law. Existing cases may provide evidence for relatively general hypotheses – for example, the proposition that foreign investors sometimes challenge measures motivated by environmental concerns[270] – or for more specific propositions – for example, the proposition that states sometimes cite environmental concerns as a justification for measures that do not appear to have been

[268] Susan Franck, 'Empiricism and International Law' (2008) 48 Virginia Journal of International Law 767, 807.

[269] Trachtman (n 253) 46.

[270] Luke Eric Peterson, 'Parties in *Vattenfall v Germany* Case Suspend Proceedings' (2010) IA Reporter < http://ezproxy.ouls.ox.ac.uk:4998/articles/20100319_6> accessed 30 January 2010.

motivated by those concerns.[271] Both these hypotheses are relevant to the process of drawing inferences as to the likely consequences of various levels of protection.

A significant weakness of existing decisions as an evidentiary source is selection bias. Situations in which foreign investments operate profitably and with cordial relations with the host government do not tend to result in investor-state disputes; those in which a host state treats a foreign investor poorly are more likely to end up before a tribunal. Inferences drawn from the set of cases that result in disputes are likely to be unreliable, unless this bias in the evidentiary basis is taken into account. Selection bias may explain why certain commentators perceive foreign investors to be treated poorly in comparison to domestic investors,[272] notwithstanding evidence from systematic studies suggesting that, on average, foreign investors are not treated more poorly than domestic investors.[273]

Other weaknesses of existing decisions concern the way that the facts of the case are presented. In a dispute, investors may have an incentive to argue that the investment would not have been made if it were not for a particular set of regulatory arrangements, so as to buttress an argument that changes to those arrangements violated the investor's legitimate expectations. Conversely, states may have an incentive to argue that measures challenged by

[271] *Metalclad v Mexico* ICSID Case No ARB(AF)/97/1, Award, 30 August 2000, (2001) 40 ILM 36 [69].

[272] Ratner (n 38) 483; Paulsson (n 125) 4; Wälde and Weiler (n 176) text following fn 119; Won-Mog Choi, 'The Present and Future of the Investor-State Dispute Settlement Paradigm' (2007) 10 Journal of International Economic Law 725, 735.

[273] Rodolphe Desbordes and Julien Vauday, 'The Political Influence of Foreign Firms in Developing Countries' (2007) 19 Economics & Politics 421, 447; Emma Aisbett and Carol McAusland 'Firm Characteristics and Influence on Government Rule-Making: Theory and Evidence' (2011) CEPR Discussion Papers 649, Centre for Economic Policy Research, Research School of Economics, Australian National University 22 <http://cbe.anu.edu.au/research/papers/ceprdpapers/DP649.pdf> accessed 27 December 2011; Yasheng Huang, 'Are Foreign Firms Privileged By Their Host Governments? Evidence From The 2000 World Business Environment Survey' (2005) 28 <http://dspace.mit.edu/bitstream/handle/ 1721.1/18075/4538-04.pdf?sequence=1> accessed 20 April 2011.

the investor were motivated by social or environmental goals, so as to buttress the argument that the measures were a legitimate exercise of regulatory powers.

These weaknesses do not invalidate the use of decided cases as an evidentiary source. Instead, they counsel caution in drawing inferences from decided cases about the likely consequences of levels of protection yet to be adopted. In this chapter, evidence from decided cases forms part of an integrated assessment of the likely consequences of alternative levels of protection, along with the evidence from more systematic empirical studies and insights derived from explanatory theory.

4.2.5 What is the significance of a finding that existing evidence is indeterminate, contradictory or incomplete?

A review of existing evidence may offer clear insights into particular consequences of IIT protections. The significance of such evidence to the framework developed in this chapter is clear – it supports particular inferences regarding the likely consequences of adopting alternative levels of IIT protection. A review of existing evidence may also reveal that that evidence is indeterminate, contradictory or incomplete. For example, section 4.5.3 reviews over twenty, sophisticated studies on the relationship between IITs and FDI, along with evidence of IITs effect on the pricing of risk in the political insurance market. The findings of these studies are, in some respects, inconsistent with one another; but taken together they suggest that signing an IIT does not have an impact on FDI flows that is sufficiently significant to be observed once one controls for other variables that affect FDI flows.

Insights of this sort clarify the extent of uncertainty associated with particular causal hypotheses. The degree of certainty with which the consequences of particular policy options can be predicted is relevant to the prospective evaluation of those options, as evaluation relies

on *probabilistic* inferences about likely consequences.[274] Insight into the extent of evidentiary uncertainty is also significant in that it problematises causal assumptions implicit in existing normative debate – for example, the assumption that adopting more expansive protections for foreign investors in IITs would lead to greater flows of FDI than less protective alternatives.[275] A further use of pinpointing the shortcomings of existing empirical evidence is to define an agenda for *future* empirical research.

4.2.6 Alternative approaches to theory and evidence

This section has explained and justified the approach to theory and evidence adopted in this chapter. In the interests of completeness, it is important to acknowledge that other legitimate approaches are available. In contrast to the approach adopted in this chapter, one might begin an inquiry into the likely consequences of adopting alternative levels of protection in IITs with a set of detailed case studies – constructed through interviews and archival work – which explore the conduct of investors and states under IITs as the currently exist.[276]To be sure, such an approach could not avoid the need for engagement with causal theory. Some theoretical model would need to be invoked to justify inferences about the likely behaviour of investors and states under proposed levels of protection that are drawn from observations of behaviour under existing arrangement. The key distinction between this alternative approach and the approach adopted in this chapter is that the former would rely more heavily on inductive reasoning. Deductive reasoning plays a greater role in the approach adopted in this chapter.

[274] Stokey and Zeckhauser (n 41) 8.

[275] Sanders (n 108) 367; cf Yackee, 'Are BITs Such a Bright Idea?' (n 54) 202

[276] This is the approach adopted Tienhaara (n 154) in her study into the chilling impact of IITs on environmental regulation.

While both approaches are legitimate ways to draw causal inferences, each has its own strengths and weakness.[277] An inductive approach could be expected to offer richer insights into the complex motivations of investor and state behaviour in the case studies. Such insights are particularly useful in generating hypotheses.[278] The inductive approach is less equipped to test the causal hypotheses it generates, because of the difficulties involved in abstracting from the particularities of the cases in question. This is an important consideration in the context of this chapter. Propositions about the likely effect of alternative protections are not absolute claims, such as: 'all FDI will cease if a lower level of protection is adopted'; or 'all environmental regulation will be chilled if a higher level of protection is adopted'. Rather, propositions about the likely effect of alternative levels of protection are probabilistic claims concerning patterns of behaviour considered at some level of aggregation: 'lower levels of protection will result in less FDI'; or 'more environmental regulations will be chilled if a higher level of protection is adopted'. Such propositions necessitate a certain level of abstraction from the experience of particular cases. The approach used in this thesis, which combines deductive reasoning with the testing of assumptions and predictions against empirical evidence, is better suited to testing such propositions.

4.3 Efficiency – net economic benefits (or costs)

4.3.1 The concept of efficiency

The concept of efficiency is central to economic analysis of public policy, including economic analysis of legal rules. Although the term is used in a number of specific ways, all its uses refer to maximising relationships between ends and means. Neo-classical economics is founded on the notion of Pareto efficiency. A state of affairs is Pareto efficient if

[277] Hertier (n 245) 63-66.

[278] ibid.

commodities are allocated so that no person can be made better off without making someone else worse off. Pareto efficiency is normatively desirable on utilitarian grounds, because it implies greater satisfaction of individuals' preferences.

In practice, there are very few policy choices where an option under consideration would be more Pareto efficient than the alternative. The notion of Hicks-Kaldor efficiency, which is derived from Pareto efficiency, is more useful. A policy change improves Hicks-Kaldor efficiency if the gains of those who are better off as a result of the change would be sufficient to compensate those made worse off, demonstrating the potential for Pareto improvement.[279] The difference between the two notions is that Hicks-Kaldor efficiency does not require that winners actually compensate the losers, only that they would be capable of doing so. Accordingly, Hicks-Kaldor efficiency denotes the same maximising relationship as Pareto efficiency, discarding the constraint that no person may be left worse off. In more colloquial terms, a policy improves Hicks-Kaldor efficiency if the economic benefits of adopting that policy exceed the economic costs. When economists describe a set of legal arrangements as more efficient than the alternative they are almost always invoking Hicks-Kaldor efficiency.[280] Throughout the remainder of this thesis 'efficiency' refers to Hicks-Kaldor efficiency, unless otherwise specified.

There is an ongoing academic debate over whether efficiency – the maximisation of net economic benefits – is an appropriate objective of public policy. Critics have observed that a focus on *net* economic benefits and costs leads to a disregard for the distributive impact of policies under consideration.[281] Moreover, Sen has shown that the exclusive pursuit of

[279] Cooter and Ulen (n 250) 47.

[280] Richard Posner, *Economic Analysis of Law* (Aspen Publishers 2007) 13.

[281] Guido Calabresi, 'The Pointlessness of Pareto' (1991) 100 Yale Law Journal, 1223.

efficiency is incompatible with even a mild commitment to individual autonomy.[282] These criticisms are important and well-made, yet they do not undermine the view that efficiency should be one of the criteria by which legal rules are evaluated. A rigorous examination of efficiency is especially important in the context of IITs because economic objectives provide the most plausible justification for the protection of foreign investments.[283]

4.3.2 The relationship between efficiency and other consequences

Defining the boundaries of efficiency analysis raises a number of conceptual questions. The first of these is the appropriate geographical scope for efficiency analysis. Throughout this thesis, examination of questions of efficiency is conducted from a global perspective. Adopting a given level of protection in IITs is more efficient than an alternative level of protection if the economic benefits of adopting the former would exceed the costs, regardless of to whom those costs and benefits accrue. In other words, all economic costs and benefits are aggregated. The global approach to efficiency is also justified by the international spread of IITs. Most countries are affected by IITs in both the capacity of host state and of home state. For this reason, global efficiency improvements are likely to correlate with national efficiency improvements in most states. An examination of whether particular actors – host states, home states, private investors – are likely to benefit from a given level of protection raises distributive questions, which are addressed in Section 4.4 of this chapter.

A second issue is the relationship between efficiency assessment and assessment of flows of foreign direct investment. Greater flows of foreign investment do not necessarily entail *net* economic benefits. In the absence of externalities, the most efficient situation is for each investment project to be undertaken by the firm that can produce at the lowest cost,

[282] Amartya Sen, 'The Impossibility of a Paretian Liberal' (1970) 78 Journal of Political Economy 152, 157.

[283] Federico Ortino, 'The Social Dimension of International Investment Agreements' (2005) 7 International Law FORUM du droit international 243, 244.

regardless of nationality.[284] However, this thesis proceeds on the basis that increases in FDI flows are independently normatively desirable. This decision is partly justified by social scientific research suggesting that FDI brings benefits – that is, positive externalities – over and above domestic investment, particularly to developing countries.[285] It is also a matter of convention; much of the existing literature on IITs proceeds on the basis that FDI is a benefit, or at least a perceived benefit, to host countries. Ultimately, the decision to attribute independent normative significance to FDI flows is of little consequence, because existing evidence does not suggest a significant relationship between investment treaty protection and FDI flows. Nevertheless, it is important to note that there is a tension, at a theoretical level, in regarding both efficiency and greater FDI flows as normatively desirable.

A third issue is whether a given consequence should be subsumed into the efficiency analysis or characterised as an incommensurable consequence to be valued on its own terms. In this thesis the concept of efficiency is used to assess the consequences of a decision on the production and allocation of resources that are capable of being sold as commodities under existing institutional conditions. The likely consequences of alternative levels of protection for the realisation of human rights, environmental conservation and the rule of law are assessed separately to the efficiency calculus. (The relationship between the aggregated analysis of net economic benefits and the disaggregated analysis of the distribution of costs and benefits raises specific issues, which are discussed in section 4.4.3.1.) The boundary between efficiency analysis and other consequences is justifiable on both theoretical and practical grounds. The theoretical basis for treating gains and losses of tradable commodities as commensurable with one another is that these gains and losses could be converted into

[284] Vandevelde,'Political Economy of a BIT' (n 59) 624.

[285] Theodore Moran, Edward Graham and Magnus Blomström, 'Introduction and Overview' in Theodore Moran, Edward Graham and Magnus Blomström (eds), *Does Foreign Direct Investment Promote Development?* (Institute for International Economics 2005) 4.

other commodities at prevailing market prices, independently of the subjective value that particular individuals would attribute to the particular commodities involved. This is why gains of apples can be valued in terms of losses of oranges, while improvements in freedom of speech cannot be valued in terms of losses of oranges. The practical justification for limiting efficiency analysis to tradable commodities is to provide a distinction between 'economic' and 'non-economic' values. This permits inferences to be drawn about the net economic benefits of different levels of IIT protection, while preserving the central insight of incommensurability – that there are likely to be further non-economic consequences that should not be valued within a single metric.

4.3.3 Theory and evidence in the efficiency analysis

This section considers the likely consequences of adopting particular levels of protection primarily from a theoretical perspective. In doing so, it draws on a well-established literature in law and economics concerning the likely economic costs and benefits of legal rules. However, this theoretical analysis ultimately rests on a set of empirical hypotheses – hypotheses concerning the likely behaviour of various actors in various situations. This section articulates and critically evaluates these underlying assumptions against evidence. For example, it argues that the assumption that investors maximise profits is likely to be a much more accurate behavioural hypothesis than assumptions about the way governments respond to incentives created by legal rules. Empirical evidence is integrated into the theoretical analysis in other ways. For example, theoretical arguments suggest that IIT protections may create net economic benefits to the extent they redress discrimination against foreign investors. Whether states do discriminate against foreign investors is an empirical question, and evidence relating to this question is considered.

A different approach to the approach adopted in this section – an approach based on theory but complemented by evidence – would be to infer the net economic benefits (or

costs) of alternative levels of protection from a set of case studies. Such an approach would face serious evidentiary and conceptual difficulties. First, measuring the economic costs and benefits of an investment project is more complex than one might imagine; it is a very different question to measuring the size of the investment made by the investor. While the economic return on an investment would count as a benefit, it would need to be offset against the opportunity cost of the return foregone on capital that might have been deployed elsewhere. Similarly, the employment created by a project would count as a benefit, but one would need to offset this against the opportunity cost of labour that might have been deployed elsewhere. In addition, one would need to measure the benefit of positive externalities, such as knowledge transfer, as well the cost of negative externalities, such as economic loss resulting from pollution. This list of evidentiary difficulties in measuring costs and benefits associated with individual investments is illustrative rather than exhaustive. (Theoretical approaches based on law and economics resolve these difficulties by assuming that the cost of inputs to an investor, including the cost of capital, reflects their opportunity cost. This means that that, in the absence of externalities, the profitability of a project reflects its net economic benefit.)

Secondly, even if one were able to measure the *net* economic benefit of a particular foreign investment, there remain difficult question as to the inferences that could be drawn from such studies about the likely consequences of alternative levels of protection. One would also need to consider a range of more complex counter-factual questions – for example, if one concludes that the investment in the case study would not have proceeded under an IIT conferring a given level of protection, one would need to consider whether other investment projects would have been able to proceed as a result.

These difficulties in drawing inferences about the likely economic costs and benefits of adopting alternative levels of protections from case studies are not intended to suggest that

such an approach would be illegitimate, or that it would not generate real insights. Rather, they illustrate that each approach has its strengths and weaknesses. This justifies the view that the approach taken in this section is a legitimate approach.

4.3.4 Free markets and competitive equality: a basic efficiency analysis

There are surprisingly few articles examining the economics of foreign investment protection. Most of the existing academic literature on international investment and efficiency addresses the question of investment liberalisation.[286] Those articles that do examine the impact of investment protection on economic efficiency have taken sophisticated approaches to narrow questions.[287] In the interests of clarity, it is preferable to outline a more basic understanding of the impact of investment protection on economic efficiency before engaging with more complex issues of externalities and regulatory efficiency. This simple analysis shows why the principle of competitive equality – or non-discrimination – should be the point of departure for any efficiency analysis of investment protection.

The foundation for examining the effect of IIT protections is the neo-classical theory of markets. This theory is based on a number of simplifying assumptions, including perfect information about investment opportunities, zero transaction costs and no externalities to production that are not reflected in prices. In a simplified world of this sort, competitive equality among producers – within and between industries – will lead to the most efficient organisation of production. This is because more efficient firms will be able to produce more profitably than less efficient firms under conditions of competitive equality. Greater potential profitability – all other things being equal – means that efficient firms will win investment

[286] eg GDA MacDougall, 'The Benefits and Costs of Private Investment from Abroad' (1960) 36 Economic Record 13; Dominick Salvatore, *International Economics* (9th edn, John Wiley & Sons 2007) 427.

[287] Emma Aisbett, Larry Karp and Carol McAusland, 'Compensation for Indirect Expropriation in International Investment Agreements' (2010) 1 Journal of Globalization and Development 1.

contracts and expand their production at the expense of less efficient firms. The outcome is a more efficient organisation of production (from a global perspective). This association between competitive equality and efficiency is a foundational and uncontroversial economic result.

The application of this model to investment treaties is relatively straightforward. Legal rights that entitle firms to compensation for certain classes of loss are valuable. If all firms are granted the same legal rights a situation of competitive equality prevails. The model implies that if some firms are granted legal rights beyond those of their competitors, the privileged firms will be able to expand their market share at the expense of their more efficient competitors.[288] On this basis, IIT protections that confer equal legal status to domestic and foreign investors are likely to increase efficiency. IIT protections that confer legal rights on foreign investors that go beyond the legal rights of domestic investors will tend to reduce efficiency.[289]

One objection to this simplified treatment of efficiency is that foreign firms may face practical obstacles in their regulatory relationships with government that similarly situated domestic firms do not face, despite being entitled to equal treatment as a matter of law. If this were the case, the ideal solution would be to improve government conduct – for governments to treat all firms equally. However, given the difficulties of reforming national bureaucracies, it might be argued that conferring additional legal rights on foreign firms is a simpler and more effective way to redress foreigners' initial disadvantage. This argument is implicit in

[288] Vandevelde, 'Economics of BITs' (n 61) 478; Stiglitz (n 62) 468.

[289] The corollary of this argument – that it is inefficient (in the absence of externalities) for governments to grant an advantage to a class of domestic firms over their foreign competitors – is widely accepted in the literature on competition law and state aid. See, Christian Ahlborn and Claudia Berg, 'Can State Aid Control Learn from Antitrust? The Need for a Greater Role for Competition Analysis under State Aid Rules' in Andrea Biondi, Piet Eeckhout and James Flynn (eds), *The Law of State Aid in the European Union* (Oxford University Press 2004) 50.

many of the justifications for IITs asserted by lawyers – for example, the suggestion that the international legal rights of foreign investors are a counter-balance to the political influence of domestic firms,[290] or systemic bias in domestic courts.[291] The underlying structure of argument has been formalised in the economic theorem of the second best. The theorem implies that if there is a departure from conditions of perfect competition then a further, compensating, distortion may increase efficiency (while still resulting in a less efficient outcome than the removal of the original obstacle to perfect competition).[292]

On closer examination, there are important limitations to the argument that IIT protections are an efficiency-improving counter-balance for domestic firms' political influence. Administrative discrimination against foreigners might provide an efficiency justification for strong national treatment protections, even if domestic firms are not protected by reciprocal legal rights to be treated no worse than foreign investors. Similarly, discrimination against foreigners in domestic courts could, plausibly, justify foreign investors' entitlement to initiate investor-state arbitration, which domestic investors are unable to utilise. However, it is difficult to see how the objective of redressing either form of discrimination is advanced by substantive standards of protection that are defined without reference to the way in which similarly situated domestic investors are treated.

There are further empirical limitations to the applicability of 'second best' arguments to IITs. To the extent that evidence exists, it suggests that foreign investors are not at a disadvantage in their dealings with host governments compared to domestic firms.[293] This

[290] Ratner (n 38) 483; Paulsson (n 125) 4.

[291] Wälde and Weiler (n 176) text following fn 119; Choi (n 272)735.

[292] Richard Lipsey and Kelvin Lancaster, 'The General Theory of the Second Best' (1956) 24 The Review of Economic Studies 11, 16

[293] Desbordes and Vauday (n 273) 447; Aisbett and McAusland 'Firm Characteristics and Influence on Government Rule-Making' (n 273) 22; Huang (n 273) 28. There is also some discussion of the 'liability of

does not exclude the possibility that there are certain particular states in which foreign investors suffer discrimination. However, even in such states, IIT protections beyond rights to equivalent treatment to domestic investors go beyond what is needed to compensate for administrative discrimination. In conclusion, in the absence of externalities, levels of protection that put foreign investors in a better position than domestic investors are likely to be less efficient than alternatives that put foreign and domestic investors in an equivalent legal position.

4.3.5 Efficient government and investor conduct

One of the most common justifications for laws requiring governments to compensate property-owners for expropriation of their property is that such laws encourage *governments* to make more efficient decisions.[294] A closely related issue is whether such laws encourage *investors* to make more efficient investment decisions. While these arguments normally focus on the question of compensation for expropriation, the underlying economic analysis is not specific to the seizure of assets. The analysis is applicable to any legal rule that requires a government – in some set of legally relevant circumstances – to compensate an investor for losses caused by a government measure.[295] This analysis can provide insights into the likely consequences of different levels of IIT protection.

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foreignness' in management studies journals. This literature is unhelpful for present purposes because it does not include any broad-based empirical testing of the liability of foreignness hypothesis. It also fails to distinguish between the characteristics of foreign firms that make them less efficient than domestic firms – for example, that foreign firms often face higher transport costs – and discriminatory treatment at the hands of government that puts foreign firms at a disadvantage when compared to equally efficient domestic firms. A summary of these issues is contained in Deepak Sethi and William Judge, 'Reappraising liabilities of foreignness within an integrated perspective of the costs and benefits of doing business abroad' (2009) 18 International Business Review 404, 405.

[294] Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 88.

[295] See, Aisbett, Karp and McAusland, 'Police powers, regulatory taking' (n 66) 370.

Before examining the economic arguments, it is helpful to clarify the concepts of efficient investment decisions and efficient government decisions. Efficiency, as used in this thesis, concerns the maximising of net economic benefits. A more efficient investment decision is a decision that creates greater net economic benefits, regardless of to whom those benefits accrue. The profitability of an investment project is a first approximation of the efficiency gain of undertaking the project because profit represents the excess of economic benefits of production over economic costs.[296] However, externalities – external costs and benefits of production that do not accrue to the investor – mean that the (un)profitability of a project does not necessarily imply its (in)efficiency.

The efficiency of a government decision can be understood in the same way. Government measures pursue a range of objectives, both economic and non-economic. Regardless of the end pursued by a government measure, it will have range of consequences including a set of economic impacts – gains and losses that accrue to those affected directly or indirectly by the measure. A more efficient government measure is a measure that leads to greater net economic benefits. Efficiency is not the only criterion by which government decisions should be assessed; yet, efficiency is a desirable characteristic of all government measures, regardless of the end a particular measure pursues. If two measures are equally effective in achieving a common objective and indistinguishable in their other consequences, the more efficient measure should be preferred.

4.3.5.1 The efficiency of government conduct: the problem of fiscal illusion

The argument that compensation requirements induce more efficient government decision-making is premised on the assumption that public decision-makers tend to undervalue the

[296] Lawrence Blume and Daniel Rubinfeld, 'Compensation for Takings' (1984) 72 California Law Review 569, 588.

economic costs of a decision that fall on private actors.[297] This presumed bias is commonly termed 'fiscal illusion'. A compensation requirement might assist in redressing fiscal illusion by forcing government decision makers to reflect on the costs that the measure under consideration would impose on affected individuals and factor these costs into the overall evaluation of that measure.[298] The extent to which government decisions are likely to be influenced by the IIT protections owed to foreign investors – and whether this influence is likely to lead to more efficient decisions – is an empirical question.

'States' are highly complex institutions,[299] and a set of internal dynamics mediate between legal obligations assumed at the national level and their impact on government decision-making. A whole range of legislative and executive decisions, made by different tiers of government, could potentially become the subject of a claim made by a foreign investor. The associated processes of decision-making, and their sensitivity to a national government's obligations to compensate foreign investors, can be expected to vary both within and between countries.

The sensitivity of the decision-making processes of various arms and agencies of government to liability rules placed on the state (at the national level) is, ultimately, an empirical question. However, there is little evidence on the impact of IITs on government decision-making prior to the initiation of arbitral proceedings, and even less evidence on the extent to which this impact could be expected to vary with the level of protection conferred by IITs. While some developed states are now beginning to commission impact studies on IITs, such studies have, so far, been limited to the assessment of consequences of increased FDI flows caused by the treaty in question. They have not considered whether IITs affect

[297] Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 88.

[298] Blume and Rubinfeld, 'Compensation for Takings' (n 296) 621.

[299] Anne-Marie Slaughter, *A New World Order* (Princeton University Press 2004) 5.

government decision-making.[300] Perhaps more promising is evidence that a handful of states have instituted internal processes to share information between various arms and agencies of government about the state's obligations under IITs. UNCTAD cites the examples of the NAFTA parties – Canada, US, Mexico – Malaysia, Philippines and Peru.[301] Other states may have similar mechanisms in place. Institutionalisation of IIT protections in such countries can be expected to encourage government decision-makers to pay greater attention to the risk of their actions breaching an IIT protection. However, little empirical work has been done to examine the effects of such mechanisms.

This shortage of empirical evidence is not unique to IITs. Academics writing on the liability of public authorities within national legal systems have noted the lack of evidence of the consequences of such legal rules.[302] To the extent that scholars of domestic law have investigated these issues empirically, they have tended to focus on the volume of litigation and quantum of damages awarded in cases brought against government authorities, rather than the effect of these cases on government authorities' decision-making processes.[303]

In the absence of detailed empirical evidence, it is useful to consider the theoretical argument that providing legal protection to foreign investment is likely to lead to more efficient government decisions. The argument is based on the behavioural assumption that

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[300] See, Markus Gehring, 'Impact Assessments of Investment Treaties' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 164.

[301] UNCTAD, *Investor State Disputes: Prevention and Alternatives to Arbitration* (United Nations 2010) 66-74.

[302] Alex Marsh, 'The impact of liability on public bodies' (2008) 3 <http://www.bristol.ac.uk/sps/aboutus/sps-staff-details/marsh/> accessed 18 February 2011; Cherie Booth and Daniel Squires, *The Negligence Liability of Public Authorities* (Oxford University Press 2006) 227; Daryl Levinson, 'Making Government Pay' (2000) 67 University of Chicago Law Review 345, 416.

[303] eg Basil Markesinis and Jorg Fedtke, 'Damages for the negligence of statutory bodies' [2007] Public Law 229; Theodore Eisenberg and Stewart Schwab, 'The Reality of Constitutional Tort Litigation' (1987) 72 Cornell Law Review 641.

decision-makers tend to under-estimate (or ignore) economic costs of a decision unless they are directly borne by the government. This indifference to costs borne by private actors leads decision-maker to adopt measures that entail net economic costs.[304]

By requiring host states to bear the economic cost of government measures to foreign investors, IIT protections could discourage decision-makers from taking inefficient measures of particular type: those measures that benefit the government directly at the expense of a greater cost to a foreign investor. Direct expropriation of foreign investment is the archetypal example of such a measure.[305] On the other hand, requiring decision makers to bear the costs of a policy when they cannot capture its benefits – for example, when some of the benefits of a policy change accrue to actors other than the state itself – would lead to inefficient reluctance to alter the *status quo*.[306] Furthermore, the assumption that decision-makers suffer from 'fiscal illusion' implies that they are more sensitive to the private costs that the government is forced to bear. Requiring states to compensate foreign investors for their losses, while not extending equivalent protection to other private actors, is likely to lead decision-makers to over-value the interests of foreign investors. This distortion could only be justified if it corrected a systematic bias in government decision-making, which caused government to value foreign investors' losses less than other private losses.[307] There is little evidence that a bias of this sort exists.[308] In summary, IIT protections are only likely to improve the efficiency of government conduct by discouraging a relatively narrow class of

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[304] Thomas Miceli and Kathleen Segerson, 'Regulatory Takings' (1994) 23 Journal of Legal Studies 749, 754; Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 90.

[305] Aisbett, Karp and McAusland, 'Compensation for Indirect Expropriation' (n 287) 11.

[306] Been and Beauvais (n 154) 96.

[307] This argument is developed in the domestic context in, Fischel, *Regulatory Takings* (n 393).

[308] Desbordes and Vauday (n 273) 447; Aisbett and McAusland 'Firm Characteristics and Influence on Government Rule-Making: Theory and Evidence' (n 273) 22; Huang (n 273) 28.

measures – those in which the state inefficiently extracts a direct benefit for itself at the expense of the investor.

4.3.5.2 The efficiency of investor conduct: the problem of moral hazard

The likely effect of compensation rules on investors' decisions also raises empirical questions. However, the assumption that investors' behaviour is driven by profitability – a standard assumption in the economic literature and one that has been repeatedly empirically verified[309] – means that investors' likely response to legal rules can be inferred with greater confidence. This discussion proceeds on the assumption of investor risk neutrality. Given that the investments in questions are commercial ventures owned by international actors, in contrast to family homes owned by private individuals, it is reasonable to assume risk neutrality. The following section considers whether the conclusions of this section would be altered if investors were risk averse.

To the extent that liability rules protect investors from the cost of efficiency-reducing measures such rules are likely to encourage more efficient investment decisions. This is because such compensation entitlements ensure that investors are not dissuaded from undertaking investments that entail net economic benefits by the risk of future efficiency-reducing measures.[310] The hold-up problem – that without guarantees of compensation for any future expropriation an investor may be reluctant to incur the sunk costs associated with an investment – can be understood as a special case of this more general result.[311] (The terms 'obsolescing bargain' and 'dynamic inconsistency' are sometimes used interchangeably with

[309] Trachtman (n 253) 50.

[310] Miceli and Segerson (n 304) 762.

[311] Aisbett, Karp and McAusland, 'Compensation for Indirect Expropriation' (n 287) 12, 19.

'hold-up'.)[312] This model explains the basic intuition behind the economic case for investment protection.

The corollary also follows. To the extent that compensation rules protect investors from the cost of efficiency-improving government measures they are likely to result in inefficiently high levels of investment.[313] This is because such rules encourage moral hazard – a situation in which investors fail to allow for the risk posed to contemplated investments by efficiency-improving measures.[314] This scenario is easier to illustrate with an example. It would be inefficient for an investor to sink capital into building a factory which would operate at a profit of one thousand dollars a year by dumping pollutants in a river that cause two thousand dollars a year worth of damage to a downstream oyster industry. The most efficient investment decision would be for the investor not to undertake the investment in the first place and allocate its capital to some other project. Nevertheless, an investor would be more likely to build such a factory if it knew that the government would be required to compensate it for introducing a future regulation that prohibited such dumping.

There are additional ways in which moral hazard arising from overly-expansive legal protection is likely to affect investors' behaviour. The risk to an investment posed by future, efficiency-improving government measures is, perhaps, more important in the discipline it places on investors to internalize external costs associated with their conduct by preferring globally efficient production techniques and project structures to inefficient ones. In this way, substantive protections that leave investors exposed to the risk of efficient regulatory change are likely to affect the pattern, as well as the quantity, of investment undertaken. To return to

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[312] text at n 451.

[313] Louis Kaplow, 'An Economic Analysis of Legal Transactions' (1986) 99 Harvard Law Review 515, 529; Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 81.

[314] Aisbett, Karp and McAusland, 'Police powers, regulatory taking' (n 66) 381; Stiglitz (n 62) 529.

the previous example, a rational investor that was aware of the risk of efficient regulatory change would be more inclined to incur an additional five hundred dollars of sunk cost by installing treatment facilities to prevent the discharge of pollutants, if such a technology were available. An investor that knew it would be entitled to compensation for the introduction of any new regulatory requirements would be unlikely to incur such a cost voluntarily.

4.3.5.3 Contract protection as an imperfect substitute for IIT protection

In principle, the distinction between efficient and inefficient measures is clear. In practice, determining whether a government measure is inefficient, and therefore whether compensation is likely to encourage efficient investment decisions, is likely to pose considerable evidentiary problems. To make such a judgement one would need to be able to identify and value all the economic costs and benefits of a measure, not only those that accrue to the government and the investor in question. These practical difficulties invite a consideration of alternative institutional arrangements that might be able to provide a compensation structure that encourages efficient investment.

If an investment treaty does not provide compensation to investors for the full range of potentially inefficient government action many investors can protect themselves by negotiating additional contractual protection with the host state.[315] Contractual protections can also refer disputes to compulsory international arbitration.[316] Indeed, contractual protections, agreed in project-specific negotiations that can address issues specific to the investment in question, may be more effective than general treaty protections in solving hold-up problems that would otherwise discourage efficient investment.[317]

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[315] Jason Yackee, 'Do we Really Need BITs? Toward a Return to Contract in International Investment Law' (2008) 3 Asian Journal of WTO and Health Law 121, 129.

[316] ibid.

[317] Yackee, 'Conceptual Difficulties' (n 11) 452.

The possibility of negotiating additional contract protection is not equally accessible to all investors. Investors in sectors that do not involve dealings with the host state, particularly smaller investors in such sectors, may face much higher transaction costs in attempting to secure contract-based protections.[318] However, the majority of IIT cases that have been brought up to 2011 have arisen in situations in which the investor was in a contractual relationship with the state of some sort – whether through a concession contract, contract for the supply of goods or services to the state or its citizens, or a permit or licence issued in a regulated industry.[319] For investors that would, in any case, be negotiating a contractual relationship with the host state, incorporating additional protections into the contract is unlikely to entail significant transaction costs. For such investors additional contract protection does constitute a feasible substitute for broader substantive protection through IITs.

The counter-argument is sometimes made that states would be reluctant to offer the same level of internationalised protections to individual investors in contracts as are commonly found in IITs.[320] However, if states were reluctant to offer contractual protections (an empirical question), it would suggest doubts on the part of the state about whether the benefits of offering additional contractual protections exceed the costs in the specific cases in question. It would suggest either that the state was willing to forego the investment rather than offer the additional contractual protections necessary for it to proceed, or that the state was of the view that the investment would proceed even if additional protections are not

[318] Brower and Schill (n 176) 481; Luke Nottage 'What future for investor-state arbitration provisions in Asia Pacific treaties?' (2011) East Asia Forum <http://www.eastasiaforum.org/2011/04/26/what-future-for-investor-state-arbitration-provisions-in-asia-pacific-treaties/> accessed 30 January 2012.

[319] Author's count of all publicly available investor-state arbitrations under IITs that have proceeded to the merits phase.

[320] Nottage (n 318); Brower and Schill (n 176) 482.

offered. Thus, the counter-argument is not an argument against contractual protection. It is an argument which, if it were true, would imply that existing IIT protections are unjustifiably protective of foreign investment.

While many investors could use additional contractual protection with the host state as a substitute for IIT protection from inefficient government conduct, there is no countervailing penalty that can be levied on investors if IITs provide compensation for efficient government conduct.[321] This analysis of substitutes suggests that, from the perspective of encouraging efficient investment decisions, it is preferable to establish a legal rule that errs by refusing compensation for an inefficient government measures than a rule that errs by awarding compensation for losses caused by efficient measures.

4.3.5.4 Investor risk aversion and the significance of political risk insurance

Several important contributions to the existing literature consider additional complications to the analysis raised by risk aversion among investors.[322] Risk aversion refers to a preference for more certain outcomes to less certain outcomes. A risk averse investor would prefer to incur a certain loss of one quarter of the value of its investment than to take a one in four chance that it might lose the entire value of its investment. A risk neutral investor would be indifferent between the two scenarios, as both entail a loss of 25% of the expected value of the investment in risk adjusted terms *ex ante*. From the outset it is important to note that the extent to which foreign investors are risk averse is an empirical question. There is little direct evidence on this question. While it may be reasonable to assume that private individuals considering the low probability of a catastrophic event – for example, the destruction of their

[321] Aisbett, Karp and McAusland, 'Police powers, regulatory taking' (n 66) 370.

[322] Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 86; Kaplow, 'An Economic Analysis of Legal Transactions' (n 313) 533.

family home by fire – are risk averse,[323] companies that make international investments are less likely to be risk averse. Nevertheless, this section considers whether the conclusions of the previous sections would be altered if investors were risk averse.

If investors are risk averse, then the possibility that an *efficient* government measure may destroy the value of its investment may discourage an investor from making investments that are socially efficient. This is because the risk of the loss of value of the investment exerts a disproportionately dissuasive in the investor's project assessment. The optimal solution to this problem of risk aversion is for the investor to purchase private insurance against the risk of government interference with its investment.[324] Private insurance (for which an investor must pay) allows investors to redress risk aversion, without disturbing the balance of incentives influencing the investment decision. Risk aversion of investors only alters the analysis presented in the previous section to the extent that investors are unable to insure against the risk of losses caused by efficient government conduct.

In circumstances in which investors have no access to a private insurance market, the situation is complex.[325] Broader compensation requirements on the state can encourage risk averse investors to proceed with efficient investment by protecting the investor from a wider category of losses caused by the host state, but they also encourage investors to proceed with inefficient projects by allowing investors to ignore the social costs associated with projects.[326]

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[323] Blume and Rubinfeld, 'Compensation for Takings' (n 296) 585.

[324] Kaplow, 'An Economic Analysis of Legal Transactions' (n 313) 534, 577; Blume and Rubinfeld, 'Compensation for Takings' (n 296) 592.

[325] The efficiency of various compensation rules, given investor risk aversion, is the primary focus of: Kaplow, 'An Economic Analysis of Legal Transactions' (n 313); and Blume and Rubinfeld, 'Compensation for Takings' (n 296).

[326] Kaplow, 'An Economic Analysis of Legal Transactions' (n 313) 527.

The balance between these two competing effects depends, among other things, on the extent of risk aversion.[327]

There are, in fact, well developed private insurance markets that sell political risk insurance to foreign investors.[328] In addition, many investors also have the option of purchasing insurance from government agencies sponsored by their home state, or the Multilateral Investment Guarantee Agency (MIGA).[329] While investors are not able to insure 100% of the value of their investments, investors are able substantially to reduce their exposure to political risk. The existence of these markets undermines the basic rationale for using IIT protections to solve problems of inefficiently low levels of investment that are attributable to risk aversion.

The foregoing analysis raises the question of whether IIT protections are ever capable of improving the efficiency of investment decisions in situations where private insurance is available to investors as an alternative. It is important to emphasise that the availability of private insurance would not redress the effect of the risk of *inefficient* government measures in discouraging efficient investment, regardless of whether investors are risk neutral or risk averse. This limitation is acknowledged in Kaplow's seminal article. He explicitly notes that his analysis, which concludes that private insurance is more efficient than government compensation, only applies to situations in which the government is presumed to act efficiently.[330]

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[327] Blume and Rubinfeld, 'Compensation for Takings' (n 296) 606.

[328] Lauge Poulsen, 'The Importance of BITs for Foreign Direct Investment and Political Risk Insurance: Revisiting the Evidence' in Karl Sauvant (ed), Yearbook on International Investment Law & Policy 2009/2010 (Oxford University Press 2010) 563.

[329] ibid 555, 559.

[330] Kaplow, 'An Economic Analysis of Legal Transactions' (n 313) 521.

This qualification to Kaplow's analysis is easiest to illustrate with an example. Consider an investor contemplating an investment in a 'risky' state. The investor is able to estimate, with reasonable accuracy, that there is a 25% chance that the state will expropriate its investment. Private insurance is available to protect against this risk. If insurance is actuarially fair, the cost of insurance will be 25% of the value of the investment. Even if the investor purchases the insurance, the risk of uncompensated taking would still influence the expected pay-offs of the investment in that the investor must bear the cost of purchasing insurance. As such, the investor's investment decision is affected by the risk of expropriation, regardless of whether the investor assumes the risk directly or whether that risk is reflected in the additional cost of insuring the investment. In contrast, if the host state guarantees to provide compensation for expropriation, the risk of expropriation does not influence the expected pay-offs of the investment. For this reason, the availability of private insurance does not alter the conclusions regarding the likely impact of given levels of IIT protection outlined in the previous sections.

4.3.6 Property rights and efficiency: the Coase theorem

The Coase theorem adds another dimension to the examination of the efficiency of governments' and investors' decisions. While no scholar has argued that investment treaties are justified by the Coase theorem, a discussion of its implications is warranted by its central position in normative argument in favour of the protection of property rights.[331] The Coase theorem suggests that private bargaining is capable of dealing efficiently with externalities – the provision of public goods, the control of pollution, etc – without government regulation.[332] According to the theory, if a person is performing an action that imposes costs on others, and if these costs are greater than the benefit the person derives from the activity,

[331] Stiglitz (n 62) 485.

[332] George J. Stigler, 'Two Notes on the Coase Theorem' (1989) 99 The Yale Law Journal 631, 631.

then those affected will pay the person to cease the activity.[333] To return to the example of the polluting factory, if dumping waste in a river causes losses to a downstream oyster industry that are greater than the profits of the factory, the Coase theorem suggests that the affected oyster farmers will band together and pay the polluter to cease dumping. In this way, Hicks-Kaldor efficiency can be maximised through private bargaining.

There is an extensive literature on the Coase theorem and its applicability, which goes far beyond the scope of this thesis.[334] For present purposes, it is sufficient to observe that there are two plausible arguments that investment protection promotes efficiency based on the Coase theorem: one concerning the efficiency of government measures; and a second concerning the efficiency of investors' actions. The discussion that follows examines the extent to which these arguments add to the analysis contained in the previous section.

The Coase theorem might be cited to support the view that government action is inherently less efficient than private bargaining in addressing externalities. If one accepted this view, then it would follow that foreign investment protection increases efficiency to the extent that it discourages governments from intervening in markets, thereby allowing more scope for private actors to make efficiency-improving bargains. (Such an argument should be clearly distinguished from the proposition, examined in section 4.3.5.1, that IITs can improve the efficiency of government interventions in markets.) This argument can be comprehensively dismissed. The ability of private actors to make Hicks-Kaldor optimal bargains depends on two assumptions: that they both have access to perfect information; and that there are neither transaction nor enforcement costs associated with what may be

[333] Coase, 'The Problem of Social Cost' (1960) 3 Journal of Law and Economics 1, 4.

[334] See, David Freidman, *Law's Order* (Princeton University Press 2000) 42; Calabresi and Melamed (n 196) 1094; Duncan Kennedy, 'Cost Benefit Analysis of Entitlement Problems' (1984) 33 Stanford Law Review 387, 398.

exceedingly complex multi-actor contracts.[335] Real economies are characterised by imperfect information and transaction costs and, under these conditions, there are serious impediments to efficiently dealing with externalities through private bargains.[336] Coase himself thought the assumption of zero transaction costs was 'fanciful' and saw the Coase theorem as an analytical step to better understanding how real economies operate given the existence of transaction costs.[337] These qualifications have been borne out by empirical investigation, with Ellickson famously finding that cattle ranchers whose cows encroached on farmland did not behave in the way predicted by Coase theorem.[338] Even in a world of perfect information and zero transaction costs there would be further problems of moral hazard. It may be efficient for oyster producers to pay to prevent upstream pollution by a factory, but then any other firm could threaten to set up an identical operation, and demand compensation to desist.[339] For these reasons it cannot be said, *a priori*, that government measures are less efficient than private bargains in addressing problems caused by externalities.

Second, the Coase theorem might be cited to support the view that, in protecting investors' proprietary and contractual rights, IITs facilitate private bargaining by foreign investors, thereby increasing efficiency.[340] The problem with this argument is that IITs govern foreign investors' legal relationship with host states. They do not define proprietary

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[335] Coase (n 333) 7.

[336] Stiglitz (n 62) 486.

[337] Ronald Coase, 'Nobel Prize Lecture' (1991) <http://nobelprize.org/nobel_prizes/economics/laureates/1991/coase-lecture.html> accessed 25 April 2011.

[338] Robert Ellickson, *Order Without Law* (Harvard University Press 1991).

[339] Stiglitz (n 62) 518.

[340] '... if market transaction were costless, all that matters (questions of equity apart) is that the rights of the various parties should be well-defined and the result of legal actions easy to forecast.' Coase, 'The Problem of Social Cost' (n 333) 10.

rights that foreign investors can exchange with third parties,[341] nor do they confer rights on foreign investors to bring proceedings to enforce contractual agreements with third parties. As such, Coasian arguments do not provide efficiency rationale for protecting foreign investors for losses caused by actions of the host state.

4.3.7 Summary of efficiency

This examination of the impact of investment protection on efficiency can be summarised in the following three propositions:

1. One way in which IIT protections might create net economic benefits is by redressing discrimination against foreign investors. In states in which foreign investors suffer discrimination, IIT protections that place investors in a position of competitive equality are likely to improve efficiency. In all states, IIT protections that give foreign investors greater legal rights than domestic investors are likely to decrease allocative efficiency.
2. Determining whether IIT protections improve the efficiency of government decisions raises difficult empirical questions about the influences on public sector decision-making, on which little empirical research has been conducted. There may be considerable variation in the impact of IIT protections on government decision making, both within and between states. From a theoretical perspective, IIT protections are only likely to improve the efficiency of government conduct by discouraging a relatively narrow class of measures – those in which the state inefficiently extracts a direct benefit for itself at the expense of the investor.
3. The likely consequences of alternative levels of IIT protection on investor behaviour can be predicted with much greater confidence, based on the assumption that foreign

[341] Douglas, 'Hybrid Foundations' (n 367) 197.

investors tend to maximise their returns. IIT protections that compensate investors for loss caused by inefficient government measures are likely to increase the efficiency of investment decisions. Levels of protection that provide investors for loss caused by efficient government measures are likely to decrease the efficiency of investment decisions. In addition, the net economic cost of adopting a legal rule that provides an overly broad protection to foreign investment is likely to be greater than the net economic cost of adopting a legal rule that provides an unduly limited protection to foreign investment.

These conclusions are derived, individually, from partial analyses. As a result, a given level of protection may have both efficiency-increasing and efficiency-decreasing characteristics when compared with an alternative level; an example is compensation to foreign investors for loss caused by inefficient government measures when compensation is not paid to domestic investors in equivalent circumstances. It is not possible, in the abstract, to predict whether a given level of IIT protection with both efficiency-increasing and efficiency-decreasing characteristics will have the consequence of increasing efficiency overall. An integrated efficiency analysis would depend on a range of assumptions, including assumptions about the shape of different investors' cost-curves and the profit elasticity of investment, which can be expected to vary between countries and between industries within countries.

4.4 Distributive consequences – the fair allocation of economic costs and benefits

If one were only interested in determining the net economic benefits of alternative levels of IIT protection, there would be no need to consider their distributive consequences. The only relevant question would be the likely consequences of alternative levels of protection in terms

of economic efficiency. However, there are several normative arguments in the existing literature that relate to the allocation of costs and benefits under IIT protections. The most significant of these is the argument made in the existing literature that it is *unfair* for a state to extinguish property rights that are legitimately owned by an investor without paying compensation. This is not an argument relating to the net economic costs of interference with property rights; it is an argument about the undesirability of a certain class of actor – property owners – having to bear the cost of certain government actions.

There are other good reasons for seeking to understand and evaluate the likely distributive consequences of alternative levels of IIT protection. A state that is both a source and a destination of foreign investment in roughly equal proportion may well be content to focus on the net economic benefits of IIT protections. In contrast, a state that is disproportionately a source or destination of foreign investment is likely to be interested in the question of which particular class of actor benefits most under various levels of protection.

This section begins by attempting to determine the likely distributive consequences of alternative levels of IIT protections. This is an empirical question, considered prospectively. It requires consideration of both the allocation of benefits and costs resulting from the way that disputes would be resolved under a given level of protection (*ex post* effects), and the benefits and costs that accrue to various actors as a result of changes in investor and state behaviour associated with a given level of protection (*ex ante* effects). Overall, the analysis seeks to shed light on the pattern of winners and losers associated with different levels of protection. This section then examines the implications of a range of different theories of distributive justice for the evaluation of these consequences.

4.4.1 Evidence and theory in the analysis of distributive consequences

The examination of the likely allocation of economic costs and benefits under various levels of IIT protection is an extension of the efficiency analysis developed in the previous section, which concerned the assessment of net economic costs and benefits. Due to the close relationship of this section to the assessment of efficiency, it relies on the same combination of theoretical analysis – based on hypotheses concerning investor and state behaviour – and empirical evidence as the previous efficiency analysis.

4.4.2 The nature and extent of the distributive consequences of IIT protections

4.4.2.1 The division of costs and benefits from a purely ex post *perspective*

Ignoring any impact that IIT protections have on investment or regulatory decisions, the likely division of costs and benefits between host states and foreign investors under a given level of substantive protection is relatively simple to infer.[342] If a state causes loss to a foreign investor in a manner that breaches an IIT protection, the State must compensate the investor; if a State causes loss to a foreign investor in a manner that does not breach an IIT the loss will lie with the investor (subject to domestic law and any relevant contractual arrangements). Thus, broader levels of protection are likely to benefit foreign investors at the expense of host states and narrower substantive protections benefit host states at the expense of foreign investors. To be sure, it is the honouring of a treaty obligation to compensate, rather than the obligation itself, which has an effect on the allocation of costs and benefits. However, as this thesis is limited in scope to IITs containing compulsory investor-state arbitration, it is reasonable to assume that investors have some capacity to enforce their rights and will, on occasion, choose to do so.

[342] similarly Blume and Rubinfeld, 'Compensation for Takings' (n 296) 580.

Of course, IIT protections are also likely to have some impact on the decisions of investors and states. These behavioural effects may be considerably more significant than their *ex post* effects. Nevertheless, there are still insights to be gained from an *ex post* analysis. These insights are particularly important in understanding the distributive consequences of a decision to adopt (or alter) a given level of IIT protection *at the moment of adoption*. Consider a case such a *Chevron v Ecuador (I)*.[343] In that case, Chevron (then Texaco) had invested in Ecuador at a time when the investment was not covered by an IIT. All the relevant investment decisions and regulatory decisions were made without the protection of an IIT. After Chevron had ceased operations, a BIT entered into force.[344] Chevron was then able to claim compensation for the Ecuadorian courts' outrageous delay in deciding tax cases relating to the (now concluded) investment project.[345] In these circumstances, the entry into force of the BIT resulted in an economic benefit to Chevron and an economic cost to Ecuador compared to the situation that would have prevailed if the BIT protections had not entered into force. Similarly, a decision to alter the level of protection provided by an existing IIT would entail a set of distributive consequences.

4.4.2.2 The allocation of costs and benefits from an ex ante *perspective*

When the impact of IIT protections on the behaviour of investors and states is also considered, determining the likely distribution of costs and benefits between host States and investors becomes considerably more complicated. The classic case envisaged by proponents of IITs is a situation in which, in the absence of IIT protection, investors choose not to make investments that would create net economic benefits.[346] In this case, broader substantive

[343] *Chevron v Ecuador* Interim Award, 1 December 2008.

[344] ibid [180].

[345] *Chevron v Ecuador* Final Award, 31 August 2011 [87].

[346] Anne van Aaken, 'Perils of Success? The Case of International Investment Protection' (2008) 9 European Business Organization Law Review 1, 2; Andrew Guzman, 'Explaining the Popularity of Bilateral Investment

protections aim to redress the risk of government measures affecting the value of the investment, thereby making the prospective projects viable from the perspective of investors. This situation is likely to entail economic benefits for foreign investors, who would be able to proceed with efficient projects that would not have been profitable in risk-adjusted terms in the absence of IIT protection. If IIT protections do have this effect, an empirical question for which the evidence is considered below,[347] it is likely that the host state will also benefit from such projects proceeding through tax revenue generated. The way in which economic benefits resulting from such investments going ahead are shared between the investor and the host state will depend largely on the taxation policies of the host state and other fiscal terms governing the investment.

Two other scenarios merit discussion. The first is a situation in which an investor contemplates a highly profitable prospective investment in the host state, which the investor would have undertaken even in the absence of IIT protections. In a situation of this sort, the availability of IIT protections would not affect the investment decision. Broader protections in an IIT would, however, benefit a foreign investor at the expense of the host state if a dispute arises. (This situation is an example of the *ex post* effect described above.) The second is a situation in which IIT protections encourage investors to proceed with projects that do not create net economic benefits, or to choose production techniques and project structures for potentially efficient investment that are not globally efficient. This second scenario is likely to occur when IIT provisions induce moral hazard on the part of investors.[348] This situation entails benefits for investors, as inefficient projects become

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Treaties' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 81.

[347] see section 4.5.3.

[348] see section 4.3.5.2.

profitable to the investor given the level of protection provided by the IIT. This scenario may also involve a direct benefit to the host through tax revenues flowing from the project. However, these benefits will be more than offset by the economic costs of the project in the territory the host state – economic damage to the oyster farm, in the example presented in the previous section.[349] (That the economic costs exceed the benefits follows *ex hypothesi* in this situation.)

In summary, from an *ex ante* perspective, broader IIT protections are likely to benefit foreign investors; the broader the protection, the greater the economic benefit to the investor. From the perspective of the state, the situation is more complex. The host state is also likely to benefit from broader IIT protections, to the extent that these protections encourage the investor to proceed with projects that create net economic benefits. IIT protections that go beyond what is necessary to achieve this are likely to entail net economic costs in the territory of the host state.

The balance between the *ex ante* and *ex post* distributive effects of a given level of IIT protection depends primarily on the extent to which the protection in question affects the behaviour of states and investors. If IIT protections have little impact on the behaviour of states and investors, *ex post* effects are likely to predominate; if they have a significant impact on the behaviour of states and investors, *ex ante* effects are likely to predominate.[350] The extent of behavioural impact is an empirical question, and is examined in other sections of this chapter. It is likely to vary between and within states. However, independently of questions about the extent of behaviour impacts, two important conclusions can be drawn about the situations when the *ex ante* and *ex post* effects coincide. Adopting broader

[349] see text to n 314.

[350] Miceli and Segerson (n 304) 775-776.

protections in IITs is likely to benefit foreign investors, both from an *ex ante* and an *ex post* perspective. Adopting levels of protection that go beyond what is needed to maximise efficiency is likely to entail a net cost within the host state, both from an *ex ante* and an *ex post* perspective.

4.4.3 Evaluating the distributive consequences of IITs

There is no single accepted normative theory by which to judge the desirability of different patterns in the allocation of costs and benefits. Rather, different theories of distributive justice suggest different normative criteria by which distributive outcomes should be evaluated. This section does not attempt to resolve debates about distributive justice that have filled many libraries worth of books. Instead, it begins by showing why a theory of 'compensatory' justice is not a coherent basis for evaluating the distributive consequences of alternative levels of IIT protection. It then examines three of the most influential schools of thinking on distributive justice – libertarian, egalitarian and utilitarian – and a further, narrower, set of arguments that justify compensatory transfers on the grounds that they protect identifiable minorities from discrimination. Each section explores the implications of each school for a normative evaluation on the allocation of costs and benefits between foreign investors and host states.

4.4.3.1 Disaggregation and the evaluation of distributive consequences

The earlier analysis of economic efficiency – the likely net economic benefit of adopting alternative levels of IIT protection – assessed all economic benefits and costs in the aggregate. However, certain arguments in the existing literature rely on the premise that the way in which economic costs and benefits are allocated among different actors is normatively relevant. The inferences drawn about the likely distributive consequences of IIT protections in this section are examined on this basis. The theories of distributive justice considered in the following sections constitute different arguments as to why it is sometimes appropriate to

treat economic costs and benefits. One example is libertarian theory, which requires compensation for interference with property rights, regardless of whether net economic benefits follow from uncompensated interference.

4.4.3.2 Disaggregating the state – which individuals benefit from gains and losses?

A further question concerns the ultimate distributive impacts of IITs protections on individuals. This question is *sometimes* relevant, as neither states nor corporate investors are the subject of utilitarian and egalitarian theories of justice, both of which speak exclusively to distribution among individuals. Behind a corporate investor stand shareholders. Losses to foreign investors are likely to be felt, to some extent, by shareholders as reduced dividend payments or reduced stock value.

In contrast, determining the impact of costs and benefits to the host state on the citizens of that state raises deeply complex questions that are likely to vary between states depending on their systems of government. To the extent these issues have been examined, the existing literature proceeds on the assumption that states are democratic.[351] This is not an appropriate generalisation. At the same, developing an account of the way in which losses and gains to the national budget ultimately affect taxation and spending decisions of the state would require a doctoral study of its own. For present purposes, a hypothetical democratic state and a hypothetical kleptocratic state are used as heuristic devices to explore the likely distributive implications of varying levels of IIT protections. In the hypothetical democratic state it is assumed that costs and benefits to the state are ultimately borne by the citizenry through the tax system; in the hypothetical kleptocratic state, it is assumed that costs and benefits to the state are ultimately borne by a wealthy and corrupt elite.

[351] Been and Beauvais (n 154) 105.

It is important to note that empirical challenges in disaggregating likely distributive impacts within states are of little relevance to the libertarian and political process theories of distributive justice considered below. Regardless of the internal structure of the state, libertarianism requires a state that interferes with validly acquired property rights to pay compensation. Similarly, the norms of non-discrimination articulated by political process theory set standards of fairness that are independent of government structure. As such, the internal complexity of states does not preclude a detailed assessment of the implications of these theories of justice for the evaluation of the likely distributive consequences of IIT protections.

4.4.3.3 Questions of scale in the evaluation of distributive consequences

Questions of scale have been highly controversial in existing academic debate concerning the distributive impact of IITs. Critics have noted that the $US 353 million award against the Czech government in *CME v Czech Republic* was roughly equivalent to the country's annual health budget.[352] In doing so, they are implicitly asserting that the appropriate scale for evaluating the scale of the distributive impact of IIT protections is national social expenditure foregone. In contrast, defenders of IITs have observed that the size of arbitral awards is much smaller than the amount claimed by foreign investors,[353] and even the amounts claimed by investors are relatively small when compared to the value of FDI flows. Neither of these is an appropriate scale by which to evaluate the (in)significance of the likely distributive impacts of alternative levels of IIT protection. For a state seeking to determine how much protection it should provide to foreign investment through IITs, the relevant question is whether the distributive impacts of adopting a given level of protection are significant in light of the other costs and benefits of adopting that level of protection.

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[352] van Harten, *Investment Treaty Arbitration and Public Law* (n 19) 7.

[353] Franck, 'Empirically Evaluating Claims about Investment Treaty Arbitration' (n 374) 59.

4.4.4 A theory of 'compensatory' justice cannot explain why compensation should be paid for some losses caused by the state but not others

Many lawyers invoke an intuitive conception of 'compensatory' justice in debates about IIT protections.[354] However, on critical reflection, it is clear that a theory of justice based on causation – the proposition that fairness requires compensation for losses caused by the state – provides little guidance in this context. This principle cannot assist in determining which losses caused by the state should be compensated and which losses may fairly be left uncompensated, without collapsing back into an analysis that turns on the likely net economic benefits of the various alternatives.[355] (That is, unless one argues that distributive justice requires a default rule that compensation be paid for *any* loss caused by the conduct of the host state. This is not a position that has been advanced by any commentator in the existing literature. Such a view would face serious conceptual difficulties that have been examined at length elsewhere.[356])

More sophisticated notions of 'compensatory' justice rely on implicit notions of 'harm' or 'fault'. One argument endorsed in the early 5th Amendment 'takings' jurisprudence of the US Supreme Court is that fairness requires compensation when the state acts to extract a benefit from a property owner but not when it seeks to prevent a harm.[357] This harm/benefit distinction has been heavily criticised as indeterminate in the absence of some prior theory of distributive justice:

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[354] Been and Beauvais (n 154) 100-101.

[355] Calabresi *The Costs of Accidents* (n 25) 43.

[356] Coase, 'The Problem of Social Cost' (n 333) 2.

[357] Been and Beauvais (n 154) 101.

> In the absence of some accepted standard of proper conduct, a court or legislature can describe any particular government-imposed rights change equally well as either harm prevention or benefit extraction.[358]

The Supreme Court has abandoned this distinction for this very reason:

> In Justice Blackmun's view ... the test for required compensation is whether the legislature has recited a harm-preventing justification for its action. ... Since such a justification can be formulated in practically every case, this amounts to a test of whether the legislature has a stupid staff.[359]

Arguments about why fairness requires the payment of compensation in certain circumstances must be founded on some other theory of distributive justice. Libertarian theories of distributive justice provide the most compelling justification for the view that fairness requires compensation for the interference with foreign investors.

4.4.5 Libertarian theories of distributive justice

The libertarian conception of distributive justice is based on entitlement to existing, validly acquired, property rights.[360] This school of thought is most associated with the theoretical work of Robert Nozick. However, Richard Epstein has done more than any other scholar to apply Nozickian libertarian principles to the law of property protection. Epstein observes that a full commitment to the protection of property would imply a *minimal state* unable to supply even the most basic public goods.[361] For example, an inviolable commitment to property would prevent a state from acquiring the land necessary to build roads, unless every landowner along the planned route was willing to sell their land to the state voluntarily. In such a state, every individual could be worse off than in a state with a well-designed system

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[358] Glynn Lunney Jr, 'Responsibility, Causation, and the Harm-Benefit Line in Takings Jurisprudence' (1995) 6 Fordham Environmental Law Journal 433, 435.

[359] *Lucas v South Carolina Coastal Council* 505 US 1003 (1992) per Scalia J.

[360] Robert Nozick, *Anarchy, State and Utopia* (Basil Blackwell 1974) 151.

[361] Richard Epstein, 'One Step beyond Nozick's Minimal State' (2005) 21 Social Philosophy and Policy 286, 290.

of limited public good provision.[362] Epstein argues that the appropriate theoretical response for a libertarian is to allow the state to interfere with property rights, provided that no affected individual is left worse off.[363]

Libertarian theory, based on Nozick and developed by Epstein, provides a clear normative criterion by which to evaluate the distributive effects of IIT protection: justice requires a host state to compensate a foreign investor for loss caused by interference with the investor's property rights. However, this principle applies only to compensation for interferences with an investor's rights of ownership – its legal entitlements relating to the possession, use and disposition of the property in question.[364] The libertarian claim is for the protection of legal entitlements, rather than insurance of the value of those entitlements.[365] Economic loss only comes into the analysis as the measure of compensation once a deprivation of entitlements has been established.[366] The distinction between legal entitlements and value is crucial when it comes to evaluating the distributive consequences of an IIT provision in libertarian terms. When an investor acquires an investment in a foreign country, it validly acquires a bundle of legal interests that are defined by domestic law at the time of purchase.[367] A libertarian theory of justice implies that a state should compensate an investor if it alters the scope of those legal entitlements; it does not imply that a state should compensate an investor for losses flowing from changes in policy that do not alter those legal entitlements.

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[362] ibid.

[363] ibid 293.

[364] Epstein, *Takings* (n 108) 100.

[365] Steven Eagle, *Regulatory Takings* (Michie 1996) 62.

[366] Epstein, *Takings* (n 108) 103.

[367] Zachary Douglas, 'The Hybrid Foundations of Investment Treaty Arbitration' British Yearbook of International Law 151, 197.

4.4.6 Egalitarian theories of distributive justice

Virtually all theories of justice argue for equality *of something*, whether it is equal protection of rights, equal weighting of each individual's utility, or equality of income and wealth.[368] Egalitarianism, in the sense used in this thesis, refers to the third form of equality: equality in the distribution of income, wealth and resources. It is important to recognise that egalitarian principles of distributive justice are normally embedded in wider theories of justice. So, for example, in Rawls work, every person's entitlement to equal basic liberties is a higher order principle than the difference principle, which relates to the distribution of wealth.[369] Understanding the position of egalitarian principles within wider theories of justice is crucial to fully appreciating authors' overarching normative frameworks. However, for the narrow purposes of this thesis, it is not necessary to provide an overview of complete theoretical works. It is sufficient to identify basic principles that allow evaluation of alternative distributions of economic costs and benefits in normative terms.

The work of John Rawls occupies a central position in egalitarian thought. Although different theorists incorporate egalitarian norms into their theories in different ways, the conclusions of many thinkers – among them Pogge, Cohen and Sen – are developed through criticism and extension of Rawls' ideas.[370] This thesis' characterisation of the norms of egalitarianism is based on the difference principle in Rawls' *A Theory of Justice*.[371] Rawls' difference principle can be expressed in two simple normative propositions: that primary goods, which include wealth and income, should be distributed equally; and that any

[368] Amartya Sen, *Inequality Reexamined* (Clarendon Press 1992) ix.

[369] John Rawls, *A Theory of Justice* (Revised edn, Belknap Press 1999) 53.

[370] Thomas Pogge, *Realizing Rawls* (Cornell University Press 1989) 1; Gerald A. Cohen, *Rescuing Justice and Equality* (Harvard University Press 2008) 1; Sen, *The Idea of Justice* (n 221) 1.

[371] Rawls (n 369) 53.

inequality in the distribution can be justified only to the extent it improves the position of the worst off.[372]

Some critics of IITs contend that they benefit wealthy investors at the expense of developing states, implicitly invoking an egalitarian theory of distributive justice.[373] However, in situations in which adopting a given level of protection creates economic benefits both for the foreign investor and within the host state, egalitarian concerns are unlikely to arise. While it is not possible to be certain as to how such benefits will be shared, the coincidence of mutual economic benefit means that there are no grounds for assuming that the poorest will be disadvantaged.

The potential for egalitarian concerns is limited to a situation in which a given level of protection creates economic benefits for foreign investors, but results in economic costs within the territory of the host state. Section 4.4.2.2 has argued that this situation is likely to arise if IITs confer broader protection on foreign investors than is necessary to maximise net economic benefits. This situation is likely to be undesirable for a hypothetical democratic host state, in which gains and losses to the state are ultimately borne by the citizenry through taxation, judged from an egalitarian perspective. This is because the shareholders of foreign investors that benefit are likely to be better off than the citizens of host states, who suffer the loss. This hypothesis is justified by three empirical observations. First, the investors whose claims have come to international investment arbitration are predominantly medium-large corporations from the developed world.[374] Second, in developed countries shares are more

[372] ibid 67.

[373] Sarah Anderson and Sara Grusky, 'Challenging Corporate Investor Rule' (2007) <http://www.ipsdc.org/reports/070430-challengingcorporateinvestorrule.pdf> accessed 30 January 2012.

[374] Susan Franck, 'Empirically Evaluating Claims about Investment Treaty Arbitration' (2007) 86 North Carolina Law Review 1, 29.

commonly owned, and owned in greater proportion, by the wealthy than the poor.[375] Third, the respondent states in investment claims are predominantly developing countries.[376]

In contrast, in a hypothetical kleptocratic state it is not at self-evident that benefits to foreign investors that come at the expense of actors within the host state are undesirable from an egalitarian perspective. Indeed, if all costs to the host state are assumed by a corrupt and wealthy elite, there may even be situations in which preferring the economic interests of foreign investors to those of the host state is desirable – the question turns on a comparison of the relative wealth of shareholders and kleptocrats. Accordingly, egalitarian concerns about the distributive consequence of IIT protections are best understood as limited to a relatively narrow set of situations that satisfy two conditions those situations: in which the level of protection under consideration is broader than is necessary to maximise net economic benefits; and in which the host state is broadly democratic.

4.4.7 Utilitarian theories of distributive justice

Classical utilitarianism is based on the norm of seeking 'the greatest happiness for the greatest number'.[377] Happiness, in this sense, is conventionally described as 'utility', but it is also sometimes equated with welfare, pleasure or satisfaction. Whichever word is used, the concept posits a single metric that is capable of fully describing an individual's subjective well being. If one assumes the population size to be fixed, utilitarianism calls for the maximisation of the aggregate utility of existing individuals.[378]

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[375] For example, in the UK 'wealth is considerably less evenly distributed than income' with the wealthiest half of the population owning 99% of non-dwelling, marketable wealth. Office for National Statistics, 'Share of the Wealth' (2006) <http://www.statistics.gov.uk/cci/nugget.asp?id=2> accessed 28 May 2010.

[376] Franck, 'Empirically Evaluating Claims about Investment Treaty Arbitration' (n 374) 32.

[377] This quote is customarily attributed to Bentham James H. Burns, 'Happiness and Utility' (2005) 17 Utilitas 46, 46.

[378] John Roemer, *Theories of Distributive Justice* (Harvard University Press 1996) 127.

Evaluating distributive impacts in utilitarian terms requires aggregation of the loss of utility of those who suffer economic loss and the gain in utility of those who receive economic benefits from a given level of protection. The utilitarian analysis only diverges from the efficiency analysis to the extent that people derive different levels of subjective well-being from the same amount of money. It would be almost impossible to ascertain empirically whether those who ultimately benefit from the greater wealth of foreign investors derive more subjective well-being from the same amount of money than those who would benefit from the greater wealth of host states.

Practical difficulties of this sort have led some to argue that subjective utility is an unworkable and indeterminate normative criterion by which to assess public policy.[379] Those who have invoked utilitarian norms to evaluate distributive consequences rely on the assumption that the utility of additional wealth is higher for the poor than the rich, as the poor lack for more of the things that might dramatically improve the quality of their lives.[380] Under this assumption, a utilitarian analysis roughly follows an egalitarian analysis,[381] although without the same insistence that attention focus specifically on the interests of the worst off.

4.4.7.1 Why 'demoralization costs' should not be considered as an additional factor in a utilitarian analysis

Michelman's 1967 article proposes a further, purportedly utilitarian, rationale that would justify compensating property owners who suffer economic loss caused by government action: these are termed 'demoralization costs'. It is important to address Michelman's

[379] Richard Posner, *The Economics of Justice* (Harvard University Press 1981) 33.

[380] Arthur C. Pigou, *The Economics of Welfare* (Macmillan 1932) I.VIII.3.

[381] This argument is developed in Abba Lerner, *The Economics of Control* (Macmillan 1944) 35.

arguments directly, as they have proved influential.[382] Michelman's contention that law should protect the 'investment-backed expectations' of property owners, an argument which relies on his conception of demoralization costs,[383] was subsequently accepted by the Supreme Court in *Penn Central Transportation Co v New York City*.[384] The appendices of IITs based on the 2004 US model Bilateral Investment Treaty and the 2004 Canadian model BIT now identify investment-backed expectations as one of the criteria that distinguishes indirect expropriation from legitimate non-compensable regulation.[385]

Michelman defines demoralization costs as:

> (1) The dollar value necessary to offset disutilities which occur to losers and their sympathizers specifically from the realization that no compensation is offered, and
> (2) The present capitalized dollar value of lost future production (reflecting either impaired incentives or social unrest) caused by demoralization of uncompensated losers, their sympathizers, and other observers disturbed by the thought that they themselves may be subjected to similar treatment on some other occasion.[386]

The first element of Michelman's formulation is an *additional* (additional, that is, to the economic loss suffered) 'psychological shock ... emotional protest' when individual loss due to governmental action goes uncompensated.[387] Although it is plausible to suggest that compensation rules may trigger psychological effects of utilitarian significance, Michelman does not provide an empirical basis for his contention. Later scholars have attempted to put

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[382] Other scholars have rejected demoralization costs relying exclusively on *ex ante* efficiency arguments. See, Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 81; and Kaplow, 'An Economic Analysis of Legal Transactions' (n 313), 561.

[383] Frank Michelman, 'Property, Utility, and Fairness' (1967) 80 Harvard Law Review 1165, 1213.

[384] *Penn Central Transportation Co v New York City* 438 US 104 (1978) 124.

[385] US Model BIT (n 27) annex B 4(a); Canada Model FIPA (n 27) annex B.13(1).

[386] Michelman (n 383) 1214.

[387] ibid 1228.

this demoralization effect on a firmer conceptual footing by suggesting that it results from concern that uncompensated individuals have been victimized by the majority.[388] However, this reasoning disguises a normative premise – that impartiality and non-discrimination are desirable – as a utilitarian argument. If demoralization costs rely on a truly utilitarian basis, one would also need to consider the possibility that some members of a majority derive psychological utility when they perceive that they are able to advance their interests through the political system at the expense of minorities. Alternately, the first element of demoralization costs could be a manifestation of risk aversion among property owners.[389] However, risk aversion does not provide a utilitarian justification for compensation for losses when private insurance against such risks is available,[390] as is commonly the case with foreign investment projects.

The second element of Michelman's demoralization costs relates to the consequences that flow from the effect of the relevant legal rules on investors' conduct. This simply reframes the question of whether given legal rules create net economic benefits, considered in section 4.3, as a utilitarian argument. While it is true that the risk of uncompensated losses will dissuade investors from pursuing some investment projects, this reallocation of capital to other uses does not necessarily entail net economic costs. Indeed, contrary to Michelman, compensating investors for losses caused by efficient governmental measures is likely to create net economic costs by inducing moral hazard on the part of investors.[391]

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[388] William Fischel and Perry Shapiro, 'Takings, Insurance, and Michelman' [1988] 17 Journal of Legal Studies 269, 281.

[389] Kaplow, 'An Economic Analysis of Legal Transactions' (n 313) 561.

[390] ibid 534, 577; discussed above in section 4.3.5.4.

[391] Robert Cooter, 'Unity in Tort, Contract and Property' (1985) 73 California Law Review 1, 21; Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 81; Kaplow, 'An Economic Analysis of Legal Transactions' (n 313) 561. These arguments are taken up at in detail at n 314.

4.4.8 Political process theories and distributive justice

A further school of thought argues that evaluation of the fairness of distributive transfers should be grounded in an analysis of political processes.[392] This literature is particularly concerned, first, with the risk that a majority in a given polity may use its influence over government decision-making to exploit minorities and, second, with the implications of this risk for the design of compensation rules.[393] The problem of majoritarian decision-making is cited in the course of at least three distinct arguments. The first is the argument that decisions that enrich a majority at the expense of a minority cause psychological unease, an effect which should be included in utilitarian evaluation of compensatory transfers.[394] This argument is discussed and dismissed above.[395] The second is the argument that, in the absence of rules requiring government to compensate individuals (including minorities) for losses caused by governmental measures, governments will make inefficient decisions.[396] This 'fiscal illusion' argument relates to the effect of IIT protections on states' behaviour; it has been addressed in detail.[397] The third is the argument that it is *unfair* for majorities to use political processes to gain advantages at the expense of minorities, where the supposed unfairness is independent of both utilitarian and efficiency-based evaluation.[398] This third argument is sometimes offered as justification for IIT protections, without reflection on its

[392] Been and Beauvais (n 154) 102.

[393] Saul Levmore, 'Just Compensation and Just Politics' (1990) 22 Connecticut Law Review 285, 310; William Fischel, *Regulatory Takings* (Harvard University Press 1995) 204

[394] Fischel and Shapiro (n 388) 281.

[395] Text to n 388.

[396] Fischel, *Regulatory Takings* (n 393) 206.

[397] Text to n 296.

[398] See, Fischel, *Regulatory Takings* (n 393) 217; William Fischel, 'Exploring the Kozinski Paradox' (1991) 67 Chicago-Kent Law Review 865, 911.

normative underpinnings.[399] This section addresses the third argument – that fairness may require compensatory transfers to minorities that are victims of losses inflicted on them by majorities.

Almost every government decision will confer benefits on some individuals and cause losses to others. If the only criterion for unfairness were that the outcome disadvantage a minority, political process theory would approximate Epstein's libertarianism.[400] Indeed, such a theory of fairness would be more expansive than libertarianism, in that it would require compensation for government acts that cause losses to a minority even if the losses did not flow from an interference with property rights. However, political process theorists have been anxious to distinguish their views from libertarians,[401] and acknowledge that democratic decision-making can legitimately impose costs on a minority without compensation being required.[402]

The initial challenge for political process theories, then, is to provide a normative basis to distinguish decisions resulting from 'fair' decisions from 'unfair' decisions. Levmore argues that this distinction rests on the procedural question of whether the disadvantaged minority has 'difficulty influencing political bargains' and is therefore 'unprotected'.[403] Influence, in this sense, refers to a minority's *relative* lack of capacity to access and participate in decision-making processes compared with other 'interest groups' that are

[399] Wälde and Kolo (n 80) 845.

[400] For discussion of this similarity, see John Hart Ely, *Democracy and Distrust* (Harvard University Press 1980) 136.

[401] Fischel, *Regulatory Takings* (n 393) 178.

[402] Fischel, 'Exploring the Kozinski Paradox' (n 398) 889.

[403] Levmore (n 393) 308.

affected by government decision-making.[404] The normative basis of Levmore's distinction is a procedural conception of non-discrimination: that decision-making processes should provide equal opportunity to all to articulate and defend their interests.[405]

The phenomenon of majoritarianism, however, is not unique to situations where the minority lacks opportunities for political influence. A minority may be organised, able to access decision-makers, make representations and lobby but then be out-voted by a relatively homogenous majority. Indeed, in Fischel's account of local government, such cases are presented as the archetype of unfair majoritarian exploitation of minorities.[406] This suggests that the unfairness of which political process theorists complain resides as much in the outcome of a decision-making process, as in the process itself.

The objection to majoritarian outcomes appears to be based on a substantive conception of non-discrimination:

> [M]ajoritarian, or gang, law is thought unfair because of the equal treatment principle, which is especially compelling when the community's needs would be met just as well by using any piece of land...[407]

According to this account, unfair discrimination occurs when a minority is singled-out to bear a cost that might equally have been placed on others. Farber gives this understanding of non-discrimination a more coherent conceptual basis. He argues that political powerful minorities will invariably be able to obtain compensation for losses caused by government, through their influence over political processes.[408] Non-discrimination requires that less politically

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[404] ibid 306.

[405] ibid 310.

[406] Fischel, 'Exploring the Kozinski Paradox' (n 398) 886.

[407] Levmore (n 393) 309.

[408] Farber, 'Economic Analysis and Just Compensation' (1992) 12 International Review of Law and Economics 125, 137.

powerful individuals be legally entitled to equivalent compensatory transfers.[409] A substantive norm of non-discrimination, in this sense, is not grounds for objecting to all decisions that impose costs on minorities; the objection is to the *arbitrary* singling-out of particular minorities to bear uncompensated losses.[410] While the case for horizontal equity rests primarily on a normative premise of fair distribution, some have argued that equal treatment of similarly situated individuals is also desirable on the grounds of economic efficiency.[411]

The foregoing analysis shows that political process theories of fairness rely on two normative premises, both of which are based on the principle of non-discrimination: that it is unfair for government to impose uncompensated losses on minorities who are at a practical disadvantage in decision-making processes; and that it is unfair for government decision to *arbitrarily* single-out particular minorities to bear uncompensated losses.[412] The latter norm implies that IIT protections can be justified to the extent they redress situations in which foreign investors are arbitrarily singled-out to bear particular losses. With respect to the former norm, empirical evidence indicates that foreign investors are not a general class of actor that lacks influence in host state decision-making.[413] Therefore, IIT protections can only be justified by the former norm to the extent they redress specific and demonstrable instances of discriminatory exclusion from decision-making processes.

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[409] ibid.

[410] William Michael Treanor, 'The Original Understanding of the Takings Clause and the Political Process' (1995) 95 Columbia Law Review 782, 872; Glynn S. Lunney, 'Takings, Efficiency, and Distributive Justice' (1990) 99 Michigan Law Review 157, 159.

[411] Robert Innes, 'Takings, Compensation, and Equal Treatment for Owners of Developed and Undeveloped Property' (1997) 40 Journal of Law and Economics 403, 407; cf Louis Kaplow, 'Horizontal Equity' (2000) 1 <http://www.nber.org/papers/w7649.pdf> accessed 25 April 2011.

[412] Been and Beauvais (n 154) 104.

[413] Desbordes and Vauday (n 273) 447; Aisbett and McAusland 'Firm Characteristics and Influence on Government Rule-Making' (n 273); Huang (n 273) 28.

4.4.9 Summary of distributive consequences of IITs

The foregoing identification and evaluation of likely distributive consequences of IIT protections can be summarised in the following seven propositions:

1. The likely scope and extent of distributive effects of IIT protections is an empirical question, which requires consideration of both *ex post* and *ex ante* effects.
2. From an *ex post* perspective, broader levels of protection are likely to benefit foreign investors at the expense of hosts states. From an *ex ante* perspective, levels of protection that improve economic efficiency benefit both the foreign investor and the host state. In contrast, levels of protection that go beyond what is necessary to maximise net economic benefits are likely to entail economic benefits to the foreign investor, which accrue at the expense of the host state or actors within the host state.
3. Whether *ex post* or *ex ante* effects predominate is an empirical question that depends on the extent to which IIT protections influence the behaviour of investors and states. Regardless of whether *ex post* or *ex ante* effects predominate, broader levels of protection are likely to benefit foreign investors while levels of protection that go beyond what is necessary to maximise net economic benefits are to the detriment of host states (considered territorially).
4. Libertarian theories of justice suggest that validly acquired property rights should be protected. This provides a justification for the payment of compensation to foreign investors when the host state interferes with their property rights. However, libertarian theories do not justify compensation for losses that do not result from a deprivation of property rights.
5. Egalitarian theories of distributive justice suggest that legal rules are desirable to the extent they improve the position of the worst off. Egalitarian concerns about the distributive consequence of IIT protections are limited to a relatively narrow set of

situations that satisfy two conditions: those situations in which the level of protection under consideration is broader than is necessary to maximise net economic benefits; and in which the host state is broadly democratic.

6. Utilitarian theories of distributive justice suggest that different patterns in the distribution of costs and benefits should be evaluated according to their impact on aggregate subjective utility. Utilitarian concerns are limited to the same specific situations as egalitarian concerns.
7. Political process theories suggest that it is unfair for states to impose losses on minorities who were at a practical disadvantage in decision-making processes; and that it is unfair for government decisions arbitrarily to single-out particular minorities to bear losses. These two norms of non-discrimination provide a justification for IIT protections that serve either to compensate investors for decisions made through processes from which they were discriminatorily excluded, or to compensate investors for being arbitrarily singled-out to bear the costs of a governmental measure.

4.5 Attraction of foreign direct investment

4.5.1 Is additional FDI normatively desirable?

The desire to attract FDI is widely cited as an explanation for states' decisions to sign investment treaties.[414] This is not because FDI has any intrinsic normative value. Rather, FDI is sought for its supposed instrumental value in promoting positive economic externalities – 'spillover' benefits that accrue to a host state beyond those associated with other forms of investment. This raises a threshold question of whether there is any evidence to support a correlation between FDI and identifiable externalities. There is some evidence that FDI is associated with higher wages, faster productivity growth and greater diffusion of knowledge

[414] See, UNCTAD, *South-South Cooperation in International Investment Agreements* (n 4) 47.

than domestic investment, particularly in developing countries.[415] However, there is no consensus on the benefits of FDI. Some authors have argued that there are negative externalities specific to *foreign* investment;[416] others have suggested that investment in extractive sectors is associated with significant negative externalities, independently of whether that investment is of domestic or foreign origin.[417]

For the purposes of argument, this thesis accepts the simplifying assumption that increases in the volume of FDI (as opposed to impacts on the legal structure or timing of FDI)[418] correlate with positive economic externalities. There are several pragmatic justifications for adopting this assumption: it seems to be accepted by states;[419] it is accepted in most of the existing literature;[420] and attempting to disaggregate the extent to which different types of investment are associated with different externalities would complicate the analysis enormously. As the following examination leads to the conclusion that investment treaties have little impact on FDI flows, this simplifying assumption has little influence on the final analysis.

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[415] See the overview of empirical studies in Moran, Graham and Blomström (n 285) 4.

[416] Sanjaya Lall and Rajneesh Narula, 'Foreign Direct Investment and its Role in Economic Development' (2004) 16 The European Journal of Development Research 447, 461; Joshua Robbins, 'The Emergence of Positive Obligations in Bilateral Investment Treaties' (2006) 13 University of Miami International and Comparative Law Review 403, 408.

[417] Paul Collier and Benedikt Goderis 'Commodity Prices, Growth, and the Natural Resources Curse: Reconciling a Conundrum' (2007) <http://economics.ouls.ox.ac.uk/13218/1/2007-15text.pdf> accessed 5 December 2011

[418] Poulsen (n 328) 541, arguing that:

> For host countries wanting to attract investments ... the relevant question is not whether BITs have an impact on the legal structure or timing of investment, but whether they have an impact on their destination and volume.

[419] Lisa Sachs and Karl Sauvant, 'BITs, DTTs and FDI flows' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) lx.

[420] Yackee, 'Are BITs Such a Bright Idea?' (n 54) 219.

4.5.2 Evidence and theory on the relationship between IIT protections and FDI

Whether adopting a given level of IIT protection is likely to lead to greater FDI flows than an alternative level of protection is an empirical question.[421] Currently, there is no direct evidence on the association between particular levels of protection and FDI flows. There are also significant limitations to drawing inferences about the likely impact of different levels of protection from isolated case studies. This is partly because such evidence is mixed. On one hand it is clear that the timing and structure of certain investment decisions has been influenced by IITs.[422] On the other hand, there is the evidence from states such as Brazil, which has seen remarkable grown in FDI over the past two decades despite never having ratified an IIT.[423]

There are more fundamental objections to drawing conclusions from anecdotal evidence. As argued by Poulsen:

> That BITs can be important for some investors establishing investments abroad is indisputable. This is confirmed by reports of treaty shopping, for instance, where investors choose to invest from countries that have a BIT with the host country rather than investing from their home country. But the fact that BITs at times can impact how investments are structured does not necessarily imply that these investments would not have taken place in the absence of BITs. Similarly, anecdotal reports that some investors have postponed already-planned investment until BITs were in places do not tell us much about the treaties' impact on the decision to invest in the first place. ...

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[421] cf Sanders (n 108) 367.

[422] *Mobil v Venezuela* ICSID Case No ARB/07/27, Decision on Jurisdiction, 10 June 2010 [204]:

> As stated by the Claimants, the aim of the restructuring of their investments in Venezuela through a Dutch holding was to protect those investments against breaches of their rights by the Venezuelan authorities by gaining access to ICSID arbitration through the BIT. The Tribunal considers that this was a perfectly legitimate goal as far as it concerned future disputes.

[423] UNCTAD, 'Brazil: Total number of Bilateral Investment Treaties Concluded, 1 June 2011' (2011) <http://www.unctad.org/sections/dite_pcbb/docs/bits_brazil.pdf> accessed 20 January 2012; UNCTAD, *Investment Policy Review of Brazil* (United Nations 2005).

> Similarly, the fact that multinationals are often involved in the development of capital-exporting states' BITs does not in itself imply that the absence of BITs would make them invest less or elsewhere.[424]

For these reasons the appropriate starting point for an empirical inquiry is studies that have attempted to examine the link between IITs and FDI systematically. Several studies have analysed empirical data on the link between BITs (existing studies focus on *bilateral* investment treaties) and FDI. Other studies have surveyed corporate executives, in house counsel and political risk insurers on the impact of IITs on their investment and risk-pricing decisions respectively. These studies are sufficient to test some basic hypotheses about the relationship between alternative levels of protection and FDI. For example, if the existence of IITs does not increase FDI flows, it is highly unlikely that FDI flows will be influenced by variations in the level of protection within such treaties. As this section argues that empirical evidence on the relationship between IITs and FDI is inconclusive, it goes on to consider the implications of the two main theories linking IITs to FDI. This analysis would be relevant if future empirical evidence revealed that IITs did influence FDI.

4.5.3 Empirical evidence on the relationship between BITs and FDI

A survey of econometric studies examining the connection between BITs and FDI reveals fifteen studies that claim statistically significant findings to support the hypothesis that signing BITs increases FDI.[425] This count includes: studies that find that only some types of

[424] Poulsen (n 328) 541, 551 (citations omitted).

[425] Salacuse and Sullivan, 'Do BITs Really Work?' (n 56) 149; Buthe and Milner (n 58) 213; Eric Neumayer and Laura Spess, 'Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 247; Deborah Swenson, 'Why do Developing Countries Sign BITs?' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 455; Peter Egger and Michael Pfaffermayr, 'The Impact of Bilateral Investment Treaties on Foreign Direct Investment' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 262; Robert Grosse and Len Trevino, 'New Institutional Economics and FDI Location in Central and Eastern Europe' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 288; Gallagher and Birch (n 246) 305; UNCTAD, 'The Impact on Foreign Direct Investment of BITs' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign*

BITs increase FDI;[426] two studies reporting apparently contradictory findings – one that only US BITs increase co-signatories' FDI and another that most BITs increase FDI but US BITs do not increase co-signatories' FDI from the US;[427] a study that finds only a 'minor and secondary' relationship between BITs and FDI;[428] and a study that finds that BITs increase FDI but with diminishing returns of FDI to each additional BIT a country signs.[429] A further six studies reject the hypothesis that BITs increase FDI.[430]

Direct Investment (Oxford University Press 2009) 347; Tom Coupé, Irina Orlova and Alexandre Skiba, 'The Effect of Tax and Investment Treaties on Bilateral FDI Flows to Transition Economies' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 709; Rashmi Banga, 'Impact of Government Policies and Investment Agreements on FDI Inflows' (2003) 34 <http://www.icrier.org/ pdf/WP116.PDF> accessed 5 May 2010; Sokchea Kim, 'Bilateral Investment Treaties, Political Risk and Foreign Direct Investment' (2007) 11 Asia Pacific Journal of Economics & Business 6, 22; Peter Egger and Valeria Merlo, 'The Impact of Bilateral Investment Treaties on FDI Dynamics' (2007) 30 The World Economy 1536, 1546; Chang Hoon Oh and Michele Fratianni, 'Do Additional Bilateral Investment Treaties Boost Foreign Direct Investment?' (2010) 17 <http://mofir.univpm.it/files/working%20paper/Mofir_43.pdf> accessed 8 August 2010; Matthias Busse, Jens Königer and Peter Nunnenkamp, 'FDI Promotion through Bilateral Investment Treaties' (2008) 27 <http://www.econstor.eu/bitstream/10419/4227/1/kap1403.pdf> accessed 5 August 2010; Andrew Kerner, 'Why Should I Believe You? The Costs and Consequences of Bilateral Investment Treaties' (2009) 53 International Studies Quarterly 73, 97.

[426] Banga (n 425) 34; Kim (n 425) 22.

[427] Salacuse and Sullivan, 'Do BITs Really Work?' (n 56) 148; Gallagher and Birch (n 246) 305.

[428] UNCTAD, 'The Impact on FDI of BITs' (n 425) 347.

[429] Oh and Fratianni (n 425) 17.

[430] Jennifer Tobin and Susan Rose-Ackerman, 'Foreign Direct Investment and the Business Environment in Developing Countries' (2005) Yale Law and Economics Research Paper No 293, 31; Mary Hallward-Driemeier, 'Do Bilateral Investment Treaties Attract FDI? Only a Bit ... And They Could Bite' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 374; Jason Yackee, 'Do BITs Really Work? Revisiting the Empirical Link between Investment Treaties and Foreign Direct Investment' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 390; Emma Aisbett, 'Bilateral Investment Treaties and Foreign Direct Investment' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 414; Wasseem Mina, 'External commitment mechanisms, institutions, and FDI in GCC countries' (2009) 19 International Financial Markets, Institutions and Money 371, 383; Axel Berger and others, 'More Stringent BITs, Less Ambiguous Effects on FDI? Not a Bit!' (2010) 7 <http://www.ifw-members.ifw-kiel.de/publications/ more-stringent-bits-less-ambiguous-effects-on-fdi-not-a-bit/kwp_1621> accessed 20 April 2011.

There are several obstacles to reliably testing the causal relationship between FDI and BITs. They include: measurement problems – finding data on financial flows and determining which financial flows should count as FDI;[431] coding issues – for example, determining whether all BITs or only those with certain characteristics (such as compulsory investor-state arbitration) constitute the independent variable;[432] and endogeneity problems – disentangling reverse-causality effects and controlling for policy shifts made concurrently with the signing of BITs.[433] The first two problems are easier to address than the third. Although there is no objective way to determine what should count as FDI, so long as the way flows are measured is consistent over time, one can identify trends. Similarly, while a significant weakness of some studies is that treat BITs with compulsory investor-state arbitration as equivalent to BITs that cannot be enforced in this way, there is no obstacle to addressing this problem through more thoughtful coding.

In contrast, controlling for other variables that may influence FDI raises exceedingly difficult problems. One should be particularly sceptical of studies that do not explicitly recognise the difficulties posed by endogeneity issues. For example, Egger and Merlo examined the impact of BITs on FDI in Central and Eastern Europe without controlling for the economic policy changes in these states that accompanied the transition from communism in the 1990s – policy changes that might reasonably be expected to have had an independent impact on FDI.[434] The findings of all studies should be evaluated in light of their respective methodologies.

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[431] Lowe, *Changing Dimensions of International Investment Law* (n 62) 38.

[432] Yackee, 'Conceptual Difficulties' (n 11) 441.

[433] Aisbett, 'BITs and FDI' (n 430) 396.

[434] Egger and Merlo, 'The Impact of Bilateral Investment Treaties on FDI Dynamics', 1541. For discussion, see Hallward-Driemeier (n 430) 360.

Overall, the studies that better control for endogeneity appear less likely to find a causal relationship between BITs and FDI.[435] Indeed, in an important article, Aisbett shows that the results of two of the studies supporting a causal link between BITs and FDI – those of Neumayer and Spess and Salacuse and Sullivan – are not robust once endogeneity effects are controlled for.[436] That the findings of studies which support a relationship between BIT-FDI are not consistent with one another raises further concerns about their reliability. Together, the issues of endogeneity and consistency cast doubt on the hypothesis that BITs increase FDI.

This assessment of the econometric evidence is supported by recent empirical work conducted by Poulsen. In a detailed series of interviews with private and government-sponsored political risk insurers, Poulsen found that the existence of an IIT covering a proposed investment had little impact on the pricing of political risk insurance. These findings are supported by Yackee's econometric analysis of the relationship between political risk ratings and the number of BITs a country has ratified. This study concludes 'either that BITs have no statistically significant impact on political risk ratings, or, if they do have an impact, it is quite small.'[437] Both studies are significant because they suggest a judgement that IITs do not significantly reduce the political risks facing foreign investment. Moreover, Poulsen's findings imply that investors who pay to insure against political risks have little financial incentive to prefer to invest in states covered by a BIT.

[435] Hallward-Driemeier (n 430) 358; Yackee, 'Do BITs Really Work?' (n 430) 389; Aisbett, 'BITs and FDI' (n 430) 414.

[436] Aisbett, 'BITs and FDI' (n 430) 395, 410.

[437] Jason Yackee, 'Do Bilateral Investment Treaties Promote Foreign Direct Investment? Some Hints from Alternative Evidence' (2011) 51 Virginia Journal of International Law 397, 421.

Yackee has also surveyed in house general counsel of seventy-five Fortune 500 companies. He asked a series of questions about the level of awareness of BITs, and about their impact on company investment decisions. Yackee concludes:

> Overall, the responses indicate a low level of familiarity with BITs, a pessimistic view of their ability to protect against adverse host state actions, and a low level of influence over FDI decisions.[438]

On the other hand, in an Economist survey of 602 corporate executives, 19% responded that the existence of an international investment agreement influenced their investment decisions 'to a very great extent'.[439] Although doubts have been raised about the reliability of this study's results,[440] it does suggest that IITs play at least some role in influencing the destination and volume of FDI in some countries.

In summary, BITs do not have such a substantial effect on FDI that it has been consistently identified in studies that use different data sets and methodologies. This itself is an important conclusion – it rules out the possibility of a strong effect of IITs on FDI. However, there is not sufficient evidence to reject the hypothesis that BITs have some lesser effect on FDI flows. In other words, it is unclear whether BITs have, on average, a minor impact on FDI or no impact at all. This is a more cautious conclusion than that reached by a recent UNCTAD review of the evidence. That review, which was significantly less

[438] ibid 429.

[439] Matthew Shinkman, 'The investors' view: economic opportunities versus political risks in 2007-11' in Laza Kekiz and Karl Sauvant (eds) World Investment Prospects to 2011 (2007) 96 <http://graphics.eiu.com/upload/WIP_2007_WEB.pdf> accessed 20 January 2012

[440] Lisa Sachs, 'Bilateral Investment Treaties and FDI Flows' (2009) World Association of Investment Promotion Agencies (WAIPA) Newsletter 5, fn 5.

comprehensive than the one conducted in this section,[441] concluded that, on balance, the evidence supports the conclusion that BITs have an indirect impact on FDI.[442]

4.5.4 The interaction between IIT protections, FDI and other international agreements

Historically, states have often signed IITs at the same time as introducing other measures to liberalise the investment climate.[443] This raises the issues of the interaction between double taxation agreements (DTTs), trade liberalisation through free trade agreements (FTAs), and membership of the WTO involving accession to the trade related investment measures agreement (TRIMs) and the Trade Related aspects of Intellectual Property Rights (TRIPs) have any impact on the analysis.[444] It is important to state this question precisely. This issue is not whether DTTs, FTAs, TRIMs and TRIPs influence FDI flows – it is highly likely that they do. The purpose of this chapter is to provide an analysis of the likely consequences of adopting alternative levels of protection in IITs, on the assumption that all other aspects of the international legal regime remain unchanged. This *ceteris paribus* approach – focusing on the issues raised by a particular policy question while assuming that other matters are held constant – is widely accepted as a valid analytic technique of policy analysis,[445] and forms the

[441] It considered only fourteen of the twenty one econometric studies identified in this thesis and did not have access to Poulson's findings.

[442] UNCTAD, *The Role of International Investment Agreements in Attracting Foreign Direct Investment to Developing Countries* (United Nations 2009) 55.

[443] ibid 57.

[444] Agreement on Trade-Related Investment Measures 1867 UNTS 3; Agreement on Trade-Related Aspects of Intellectual Property 1869 UNTS 299

[445] eg James Heckman and Edward Vytlacil, 'Econometric Evaluation of Social Programs, Part I: Causal Models, Structural Models and Econometric Policy Evaluation' in Zvi Griliches and Michael Intriligator (North-Holland 2008) 4826.

foundation for the marginalist approach of the law and economics discipline.[446] All existing studies of the relationship between IITs and FDI adopt a *ceteris paribus* approach, seeking to isolate the extent to which FDI flows can be attributed to the existence of an IIT, independently of the impact of other variables that also influence FDI.[447]

For present purposes, the issue is whether the consequences of adopting a given level of IIT protection would vary significantly depending on the presence or absence of other applicable international treaties – one example would be if broader protections in IITs increased FDI within bilateral relationships already governed by a DTT, but had no effect on FDI within bilateral relationships not governed by a DTT. This an interesting empirical issue, on which, to my knowledge, no research has yet been published. However, a brief working paper was released online in February 2012 that reports variation in the impact of IITs on FDI depending on host country circumstances. According to the paper, '[o]nly countries on the cusp of establishing good investment climates may benefit, for example by signing more comprehensive investment treaties than their peers.'[448] The data from which this conclusion is drawn have not been released, although a full version of the paper is, apparently, scheduled for publication in a forthcoming edited volume. The reported finding is controversial, as a correlation between IITs and FDI that is confined to those states that are, in any case, experiencing the most rapid FDI growth is also consistent with omitted variable bias (indeed, this is precisely the finding one would expect in a study that suffered from omitted variable bias). The authors do not acknowledge this concern in their working paper. When the study is

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[446] Mark Blaug, *The Methodology of Economics or How Economists Explain* (Cambridge University Press 1992) 59-62; Alfred Marshall, *Principles of Economics*, (9th edn, MacMillan 1920) [I.III.21].

[447] UNCTAD, *The Role of International Investment Agreements in Attracting Foreign Direct Investment to Developing Countries* (n 442) 55.

[448] Clint Peinhardt and Todd Allee, 'Different investment treaties, different effects' (2012) <http://www.vcc.columbia.edu/content/different-investment-treaties-different-effects> accessed 21 February 2012.

published it will be important to consider the robustness checks carried out by the authors to verify that their findings should not be attributed to omitted variable bias.

Theory also provides little guidance on whether the consequences of adopting a given level of IIT protection would vary significantly depending on other elements of the legal environment in the state in question. On the one hand, one might expect variation in the level of IIT protections to have more impact on FDI flows in situations in which the legal environment in the host state is otherwise unsympathetic, as the security provided by the IIT might figure more prominently in the judgements of foreign investors in these circumstances. On the other hand, one might argue that variation in the level of IIT protection is likely to have more impact in situations in which the legal environment is sympathetic, on the ground that IITs are but one 'component' of the investment regime, all of which must be in place to stimulate foreign investment. While UNCTAD has implied that the latter,[449] there is no direct evidence for this view. Moreover, it seems inconsistent with the observation that many of the worlds largest bilateral investment relationships, including those between the US and most European states, and the relationship between the US and China, are not covered by IITs. In the absence of evidence that the impact of IIT protections on FDI is contingent on the presence/absence of other international treaties, this chapter proceeds according to the *ceteris paribus* approach adopted in the existing literature.

4.5.5 Theoretical insights on investment protection and FDI

While section 4.5.3 argues that existing evidence suggests that there is no substantial connection between IITs and FDI, there remains a possibility that future studies might reveal an empirical relationship that is not being consistently picked up in the statistical analysis of

[449] ibid 55:

> BITs add a number of necessary components to the policy and institutional determinants for FDI, and hence impact FDI inflows into developing countries only indirectly.

current data sets. It is also possible that, as investors become more aware of the protections offered by IITs, IITs will become more effective in attracting FDI.[450] Current evidence is neither sufficiently robust nor sufficiently consistent to rule out either of these two possibilities. Therefore, it is worth proceeding on the assumption that ratifying IITs does increase FDI and considering what this assumption, if it were true, would imply for the effect of adopting a given IIT protection on FDI. Guidance on this relationship can be found in existing theories of the connection between IITs and FDI.

There are two, potentially complementary, theories of how IITs might induce FDI in the existing literature: commitment theory; and signalling theory. The more popular theory is that IITs act as a commitment device to solve a problem that is variously labelled the 'hold-up', 'dynamic inconsistency' or 'obsolescing bargain' problem.[451] The nature of the problem is that, while a foreign investor may wish to invest in a given state, investors will only be able to recover the cost of their investments over a number of years. In contrast, once a foreign investor sinks its capital into a project, the state can acquire an immediate benefit by appropriating (part of) that capital.[452] This situation means that the state has an incentive to appropriate the investor's assets or renege on an investment contract after the investor has sunk their capital into a project, in order to gain a greater share of the proceeds of the investment. Because foreign investors know that states have an incentive to renege, they decline to invest in the first place. In this situation, IITs could encourage FDI by allowing

[450] Hallward-Driemeier (n 430) 354.

[451] Anne van Aaken, 'Perils of Success? The Case of International Investment Protection' (2008) 9 European Business Organization Law Review 1, 2.

[452] Andrew Guzman, 'Explaining the Popularity of Bilateral Investment Treaties' in Karl Sauvant and Lisa Sachs (eds), *The Effect of Treaties on Foreign Direct Investment* (Oxford University Press 2009) 81.

states credibly to commit to not appropriating an investor's property or otherwise reneging on investment contracts.[453]

A less widely advocated theory is that IITs function as signalling devices. According to this theory investors lack information about the quality of a host state's domestic policies and institutions.[454] In this situation of asymmetric information, an IIT sends a signal to foreign investors that the state does have an adequate regime of domestic governance, encouraging the investor to invest.

There are problems with both theories. The commitment theory doesn't explain why states choose to make general commitments in IITs, rather than specific commitments to investors individually through internationalised contracts with arbitration clauses.[455] Moreover, it overlooks literature showing how commitment problems can be overcome by reputational effects in the context of repeated interactions.[456] Signalling theory relies on the assumption that it is less costly for states with 'good' regimes of domestic governance to become (and remain) parties to IITs than it is for states with 'bad' regimes of domestic governance.[457] Both theories rely on an assumption that foreign investors know about IITs *at the time of investment*, a claim that is disputed.[458] Ultimately, whether either theory is correct can only be judged by testing to see if evidence conforms to its predictions. As noted in the

[453] Neumayer and Spess (n 425) 230.

[454] Buthe and Milner (n 58) 176.

[455] Yackee, 'Do we Really Need BITs' (n 315) 130.

[456] Chris Doyle and Sweder Van Wijnbergen, 'Taxation of Foreign Multinationals' (1994) 1 International Tax and Public Finance 211, 212.

[457] Michael Spence, 'Job Market Signaling' (1973) 87 Quarterly Journal of Economics 355, 358.

[458] Mirian Omalu, *NAFTA and the Energy Charter Treaty* (Kluwer Law International 1999) 205; Franck, 'Foreign Direct Investment' (n 120) 348.

previous section, existing evidence casts doubt on both. For the purpose of argument, it is assumed that signing IITs does increase FDI by both signalling and commitment effects

According to signalling theory, the legal content of an IIT is of little direct concern to a prospective foreign investor. Foreign investors are not motivated by the possibility of relying on the substantive protections of IITs in international arbitration; rather, they are concerned with ascertaining whether a prospective host state has a good regime of domestic governance. An initial difficulty with signalling theory is that it relies on the premise that it is possible for investors to derive meaningful information about this complex network of institutions and policies from a binary proxy variable (the presence/absence of an IIT). Even if one accepts this premise, the level of substantive protection provided by IITs could only affect FDI flows indirectly, to the extent it places greater costs on states with 'bad governance', thereby allowing IITs to operate more effectively as signals. Such a connection between the legal content of IIT protections and effective signalling relies on the (empirically unexamined) causal assumption that IIT protections that penalise 'bad governance' discourage states with bad governance from becoming or remaining parties to IITs. The indirect and complex nature of these causal mechanisms suggests that the impact of the level of IIT protection on FDI flows is likely to be weak.

A further difficulty with signalling theory is that good governance is itself a complex and contested concept. While signalling theory does not explore the characteristics of a 'well-governed' state in detail, they presumably include the norms of intrinsic value identified elsewhere in this chapter. A state that respects the rule of law, acts efficiently, and realises human rights could be said to be well-governed. To the extent that investors are attracted by any (or all) of these, signalling theory suggests that IIT protections that penalise states that lack these characteristics tend to increase FDI.

Commitment theory, on the other hand, suggests that the ability of IITs to attract investment directly depends on their specific legal content. IITs attract FDI by solving the hold-up problem.[459] According to commitment theory, levels of protection that are more effective in solving hold-up problems will induce greater FDI. The hold-up problem is simply that the investor has no mechanism to prevent a state from reneging on an agreement it has struck with the investor. On this basis, commitment theory suggests that IIT protections that prevent states from opportunistically reneging on negotiated bargains made with foreign investors at the time of investment will be more effective in attracting FDI.

4.5.6 Summary of FDI

The examination of the impact of investment protection on FDI can be summarised in the following four propositions:

1. Current evidence suggests that BITs do not have a substantial impact on the destination and volume of FDI and casts doubt on the hypothesis that they have any impact on the destination and volume of FDI at all;
2. If entering IITs does not increase FDI, then adopting alternative levels of IIT protection is highly unlikely to affect FDI flows;
3. If entering IITs does increase FDI, then one would need to understand why IITs increase FDI in order to draw inferences about whether different levels of IIT protection are likely to have different impacts on FDI flows;
4. Commitment theory suggests that IIT protections that allow investors to enforce bargains they have made with host states are likely to increase FDI; signalling theory suggests that levels of protection that place greater costs on states with 'bad governance' than states with 'good governance' may increase FDI (a conclusion that

[459] Neumayer and Spess (n 425) 230.

refers normative inquiry back to the relationship between IIT protections and the realisation of the other norms identified in this chapter).

4.6 Regulatory chill: the consequences of IIT protections for the realisation of human rights and for environmental conservation

This section examines the consequences of the protections for foreign investment provided by IITs for the realisation of human rights and the protection of the environment in host states. The legal protections contained in IITs do not have any direct impact on the realisation of human rights or the protection of the environment. Any impact of IIT protections stems from their effect on the way in which host states exercise their regulatory powers – an effect sometimes described as 'regulatory chill'.[460] This section examines the extent to which adopting different levels of IIT protections is likely to affect the extent of regulatory chill, and the consequences of such chilling effects for the realisation of human rights and the protection of the environment. The analysis proceeds on the premises that the realisation of human rights and environmental conservation are both intrinsically desirable. These normative premises are unlikely to prove controversial.

4.6.1 The relationship of regulatory chill to other consequences of IIT protections

The fact that governmental measures concerning environmental conservation or human rights may become the subject of IIT arbitration does not, in itself, entail consequences for the realisation of these objectives. If host states were indifferent to the possibility of liability under IITs and maintained their preferred environmental and human rights policies despite investor opposition and unfavourable arbitral awards, the only consequence of adopting different levels of IIT protection would be to alter the extent of IITs' *ex post* distributive impacts. However, IIT protections will have consequences for the realisation of human rights

[460] High Commissioner for Human Rights (n 145) 21; Been and Beauvais (n 154) 132; \Schill, 'Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?' (n 262) 470; Tienhaara (n 154) 262.

and environmental conservation to the extent they dissuade host states from enacting or maintaining measures that are effective in realising these objectives. As such, there is likely to be an inverse relationship between the distributive consequences of IITs and regulatory chill. The more states modify their behaviour to reduce the distributive impact of IITs, the greater potential for regulatory chill. The manner and extent to which states modify their behaviour to avoid liability under IITs is an empirical question.

The relationship is more subtle between the consequences of IIT protections for the realisation of human rights and environmental conservation and the consequences for efficiency. One aspect of IIT protections' consequences for efficiency is the extent to which they induce governments to make more efficient decisions. This impact on the efficiency of government decisions and the impact on the realisation of human rights and environmental objectives are components of a single effect: the effect of IIT protections on government decision-making. As these two analyses examine components of the same effect, they should be consistent with one another. So, if evidence showed that most decision-makers are unaware of IITs at the time of making decisions and indifferent to the risk of liability under IITs when alerted to that risk, it would suggest that IIT protections have little impact on governmental decision-making. This would imply that they have little effect on the efficiency of government decisions and little effect on the realisation of human rights and environmental conservation.

Despite the need for coherence between the 'efficiency' and 'regulatory chill' analyses of governmental decision-making, there are several reasons to keep the two distinct. The first is that consequences for the realisation of human rights and conservation objectives are incommensurable with economic gains and losses. Incorporating both sets of consequences into a single analysis would require one set of consequences to be valued in terms of the other. The second is that IITs might have opposite effects on the two sets of

consequences; it is plausible that IIT protections could encourage decisions that engender net economic benefits – by forcing decision-makers to consider private costs – but less effective at realising human rights – by discouraging rights-realising measures that entail private costs. The third is that existing literature deals with these sets of consequences separately, so synthesising them into a single analysis of government decision-making would require a substantial re-orientation of existing contributions.

4.6.2 Evidence and theory in the regulatory chill inquiry

Even with highly detailed case studies, past chilling effects are difficult to identify because they require counterfactual evidence about the regulations that would have existed in the absence of the purported chilling.[461] Regulatory chill due to IIT protections is particularly difficult to isolate because, in addition to identifying a chilling effect, one must be able to exclude the possibility that it was attributable to some other cause. One would need to exclude the possibility that, despite the existence of an IIT, a state decided not to alter existing regulation out of fear of discouraging future investment and the possibility that the state cited the existence of an IIT as a public excuse, despite never having had an intention to alter existing regulation.[462] These evidentiary difficulties may explain why, with the occasional notable exception,[463] so little empirical work has been done to test the hypothesis that IIT protections cause regulatory chill. Further difficulties arise in drawing inferences about the likely extent of chilling if given level of protection were adopted from the study of past cases of involving IITs as they currently operate.

Given these difficulties with existing evidence, this section begins with an overview of theoretical arguments and implicit causal assumptions about regulatory chill in the existing

[461] Neumayer, *Greening Trade and Investment* (Earthscan 2001) 78.

[462] Tienhaara (n 154) 263.

[463] ibid.

literature. This analysis, in section 4.6.3, attempts to draw out the empirical assumptions on which existing debate rests, so that these assumptions can be tested against evidence. The review of the existing literature shows that there is remarkable agreement that government measures that breach IIT protections are more likely to be chilled than those that do not.[464] Disagreement in existing debate primarily stems from different *doctrinal* views about whether socially desirable measures are likely to breach IIT protections. Having mapped out the conceptual structure of existing debate, section 4.6.4 tests hypotheses implicit in existing debate about regulatory chill against available evidence..

4.6.3 Theoretical debate about regulatory chill in the existing literature

One starting point of existing discussions of 'chilling' effects is doctrinal inquiry – inquiry that examines whether certain types of governmental measures would give rise to liability under IIT protections. Schill, for example, argues that IIT protections will not chill unilateral state regulation to mitigate climate change because proportionate and reasonable mitigation measures would not breach IITs.[465] Similarly, Vandevelde argues that the fact that most regulatory expropriation claims are unsuccessful shows that IITs do not impede efforts to raise regulatory standards.[466] The twin assumptions which underpin the underpin the causal model implicit in this argument are that states may be dissuaded from adopting or maintaining measures that entail liability but will not be dissuaded from adopting or maintaining measures that do not. These two assumptions are foundational in existing debate.

[464] Schill, 'Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?' (n 262) 477; Vandevelde, *Bilateral Investment Treaties* (n 114) 107; Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 626.

[465] Schill, 'Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?' (n 262) 477.

[466] Vandevelde, *Bilateral Investment Treaties* (n 114) 107.

They are shared by those who argue that IITs are likely to have significant chilling effects,[467] and those such as Schill and Vandevelde who argue that they are not.

A further argument made by some critics of IITs is that uncertainty about the implications of IIT protections for specific regulatory proposals will discourage decision-makers from adopting measures that would have been permissible.[468] This is the uncertainty argument. Similarly, critics have argued that states' concern about the costs of defending claims under IITs in arbitration may chill permissible regulation.[469] This is a species of the uncertainty argument, which is only conceptually coherent if one accepts the basic uncertainty argument. Tribunals have awarded costs against unsuccessful investor-claimants, and such costs awards are more likely if it is clear from the outset that the claim has no arguable basis.[470] Accordingly, a state that was certain that a challenged measure was permissible would know that there was no risk of liability associated with maintaining the measure and could also assume that it had a strong chance of recovering costs from the investor for pursuing a spurious claim.

The division among existing contributions illustrates a useful conceptual distinction between two types of regulatory chill that might be caused by IIT protections: the chilling of measures that would clearly give rise to liability; and the chilling of measures that may not

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[467] Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 626.

[468] Steve Louthan, 'A Brave New Lochner Era? The Constitutionality of NAFTA Chapter 11' (2001) 34 Vanderbilt Journal of Transnational Law 1443, 1446; Been and Beauvais (n 154) 134; Rémi Bachand and Stéphanie Rousseau, 'International Investment and Human Rights' (2003) 21 <http://www.ichrdd.ca/site/_PDF/publications/globalization/bachandRousseauEng.pdf> accessed 10 June 2010; Howard Mann, 'Investment Agreements and the Regulatory State' (2007) 5 <http://www.iisd.org/pdf/2007/ inv_agreements_reg_state.pdf> accessed 5 June 2010; Suda (n 131) fn 103; Waincymer (n 125) 306.

[469] Been and Beauvais (n 154) 132.

[470] *Methanex v United States* Final Award, 3 August 2005, (2005) 44 ILM 1345 pt V [5], [10]. Current arbitral practice on costs is discussed in *EDF (Services) Ltd v Romania* ICSID Case No ARB/05/13, Award, 8 October 2009 [326] & Dissent Regarding Costs [4].

give rise to liability. The former type of regulatory chill is uncontroversial in the existing literature. For it to occur, at least two empirical conditions would need to be present: decision-makers would need to be aware of the existence of IITs;[471] and concerned (as opposed to indifferent) about the possibility of the state being required to compensate foreign investors.[472] For the latter type of regulatory chill to occur a third, additional, empirical condition must be present: there must be uncertainty regarding the application of IIT protections to specific proposals under consideration.

There is a further empirical distinction, within both types of regulatory chill, between the effect of investors' invocation of IIT protections on decision-makers and the extent to which decision-makers internalise IIT protections without the intercession of investors. If an affected investor threatens legal action or lobbies against an existing measure on the basis of an IIT, the relevant decision-maker will be alerted to the existence of the IIT.[473] The empirical question that follows is: do such threats of litigation have any influence on decisions to maintain or enforce existing regulations? A threat of litigation could also dissuade a decision-maker from adopting a new measure. However, for the investor to be able to threaten litigation, it would need to be aware that the adoption of a new measure was being contemplated, perhaps because the measure had been proposed in a public consultation. Collectively, these circumstances can be described as 'threat' chill. The situation is entirely different when investors have not opposed a measure on the basis of an IIT. In these circumstances decision-makers would need independent knowledge of IITs for the existence

[471] Susan Franck, 'The Legitimacy Crisis in Investment Treaty Arbitration' (2005) 73 Fordham Law Review 1521, 1592.

[472] Jack Coe and Noah Rubins, 'Regulatory expropriation and the *Tecmed* case' in Todd Weiler (ed), *International Investment Law and Arbitration* (Cameron May 2005). Most scholars accept as self-evident that states will be concerned about the risk of liability, eg Mann, 'Investment Agreements and the Regulatory State' (n 468) 5.

[473] Tienhaara (n 154) 262.

of IIT protections to have any influence on their decision-making.[474] The effect of decision-makers awareness of IIT protections on their decisions to adopt, maintain and enforce measures can be described as 'internalisation' chill.

4.6.4 Assessing empirical evidence of regulatory chill

4.6.4.1 What sort of evidence would be needed to test hypotheses about regulatory chill?

To empirically test the extent of 'internalisation' and 'threat' regulatory chill effects, different types of case studies would be needed. Investigation of cases in which foreign investors have publicly cited IIT protections in opposing regulations, including cases where the investor commences international arbitration, would be useful in identifying 'threat' chill. Some such research exists, and the factual record of arbitration proceedings provides further relevant source-material. Evidence of this sort may also provide limited insight into the effect of investors' opposition to the adoption of new measures. However, a systematic examination of 'internalisation' chill would need to focus on cases of governmental decision-making when there was no public opposition to a measure by foreign investors. To my knowledge, no such research has been published.[475]

4.6.4.2 Disaggregating the state – institutional complexity and regulatory chill

An additional complexity in the study of regulatory chill is that variation in the characteristics of decision-making bodies, both within and between countries, is likely to lead to variation in the extent of regulatory chill. Within countries, it is reasonable to hypothesise that national governments, who sign IITs, are more likely to be aware of the protections contained therein

[474] Coe and Rubins (n 472) 599.

[475] similarly, Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 607.

than sub-national governments.[476] And, as national governments will bear initial responsibility for paying any adverse award in international arbitration, they may be more sensitive to the risk of liability under IITs than decision-makers with a high degree of autonomy from national government.[477] This hypothesis is supported by a recent dispute between the owner of paper and pulp mill, US company Abitibi-Bowater, and Canada. The Canadian province of Newfoundland expropriated the assets of the Abitibi-Bowater in late 2008, ignoring the objections of the Canadian federal government and seemingly indifferent to risk of liability this action entailed at the national level.[478] The federal government ultimately settled the case $130 million Canadian, apparently having reached the view that it would be unable to defend the case on the merits.[479]

One might also expect that decision-makers in developing countries, which are less able to finance adverse arbitral awards, would be more concerned about avoiding liability under IITs than decision-makers in developed countries.[480] The fact that developing countries are less likely to have access to high quality legal expertise may also contribute to greater chilling of decision-making in those states.[481] This hypothesis receives some evidential support from situations in which, following threats of arbitration under IITs by foreign investors, the Indonesian and Costa Rican governments reversed earlier decisions to refuse to

[476] Francisco Orrego Vicuña, 'Regulatory Authority and Legitimate Expectations' (2003) 5 International Law FORUM du droit international 188, 191.

[477] Been and Beauvais (n 154) 90.

[478] Luke Eric Peterson, 'Canada settles NAFTA claim by pulp & paper company for $130 Million; spotlight turns to federal government's being on hook for actions of province' (2010) IA Reporter <http://ezproxy.ouls.ox.ac.uk:4998/articles/20100830_10> accessed 23 January 2012.

[479] ibid.

[480] Mann, 'Investment Agreements and the Regulatory State' (n 468) 5.

[481] Tienhaara 'Regulatory chill and the threat of arbitration' (n 262) 612.

grant mining permits.[482] In similar circumstances, the governments of developed countries have maintained refusals to grant mining permits, notwithstanding investor opposition.[483]

Nevertheless, each case of purported regulatory chill involves a complex interplay of factors. There is not yet sufficient evidence to reach firm conclusions about overall trends, about difference in behaviour between national and sub-national arms of government or about difference in behaviour between developing and developed states. This highlights the need for caution in making generalisations about regulatory chill; it also helps define an agenda for future empirical research.

4.6.4.3 Empirical testing hypotheses of regulatory chill I: liability and chilling

This section examines the hypothesis that states are dissuaded from adopting or maintaining measures that would give rise to liability under IITs. It concludes that this hypothesis should be qualified. A brief survey of decided cases reveals a number in which states maintained measures that purported to pursue environmental benefits, notwithstanding the ultimate expense of compensating foreign investors, among them: *Metalclad v Mexico*; *Tecmed v Mexico*; and *Santa Elena v Costa Rica*.[484] One might object that in these cases the decision-makers in question only maintained the measures that became the subject of arbitration because they mistakenly believed them to be IIT-complaint. However, the fact that states in these cases chose to pay out foreign investors, when they could have bifurcated the merits and quantum stages of arbitral proceedings and, after losing on the merits, negotiated settlements that involved the abandonment of the measure in question, serves to illustrate a simple point: states sometimes maintain measures that entail liability under IIT protections.

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[482] see text to n 499 and to n 503.

[483] *Glamis Gold v United States of America* Award, 8 June 2009.

[484] *Metalclad*\(n 271); *Técnicas Medioambientales Tecmed v Mexico* ICSID Case No ARB(AF)/00/02, Award, 29 May 2003, (2004) 43 ILM 133; *Santa Elena* (n 74).

Similarly, in two cases involving water privatisation – *Aguas del Tunari v Bolivia* and *Biwater v Tanzania* – the states in question cancelled water concession contracts, purporting to protect the right to water.[485] The arbitration in *Aguas del Tunari* ultimately settled.[486] In *Biwater* the Tanzanian government was found liable for breaching the BIT in question, although no economic loss to the foreign investor flowed from the breach.

This survey is unlikely to be representative of the effect of liability under IIT protections on regulatory decisions. Arbitration normally involves cases in which states have not been dissuaded from maintaining measures, and brings such cases to public attention. In contrast, situations where a state has been dissuaded from maintaining measures do not have an equivalent mechanism by which they are publicised. Care should be taken not to over-estimate the extent to which states maintain measures that will clearly give rise to liability.

The assumption that states will be dissuaded from maintaining measures that would give rise to liability under IITs should be qualified rather than rejected. It remains reasonable to assume that states are less likely to maintain measures that give rise to liability than to maintain measures that do not. This is consistent with existing evidence. There are several examples of states being dissuaded from maintaining measures that would have entailed liability under an IIT. For example, in *SD Myers v Canada* the government revoked a ban on PCB exports after the investor initiated arbitration,[487] a measure that the tribunal subsequently found had breached the relevant IIT (Chapter 11 of NAFTA) while it had been in force. Indeed, the cases reviewed in the following section show that, on occasion, the mere risk of liability under an IIT has been sufficient to dissuade states from maintaining measures

[485] *Compañia de Aguas del Aconquija and Vivendi Universal v Argentina* ICSID Case No ARB/97/3, Award, 20 August 2007; *Biwater Gauff v Tanzania* ICSID Case No ARB/05/22, Award, 24 July 2008.

[486] Damon Vis-Dunbar and Luke Eric Peterson, 'Bolivian water dispute settled, Bechtel forgoes compensation' [2006] Investment Treaty News 1.

[487] *SD Myers v Canada* Partial Award, 13 November 2000.

that may well have been IIT compliant. In contrast, there are no documented cases in which the prospect of a human rights or environmental measure triggering liability under an IIT has encouraged a state to adopt that measure (a situation that would be profoundly counter-intuitive).

Requiring the state to compensate foreign investors for losses resulting from a regulatory decision adds a cost to maintaining that decision.[488] All other things being equal, the expense of liability is likely to make decision-makers less inclined to maintain a decision. As argued above, this hypothesis is accepted by both proponents and critics of IITs as the foundation for debate about regulatory chill. These chilling effects are likely to be stronger in states in which internal procedures have been established to encourage compliance with IITs.[489] This conclusion is sufficient to allow some inferences to be drawn about the likely consequences of different levels of IIT protection.

These chilling effects are likely to be stronger in cases in which investor has opposed a measure or threatened arbitration, than situations when decision-makers consider the adoption of new measures. There is a dearth of evidence relating to 'internalisation' effects of this sort,[490] and little evidence of the impact of liability rules on government decision-making in domestic legal systems, which might provide guidance by way of analogy.[491] Coe and Rubins argue that administrative decision-makers that do not have direct or regular dealings with foreign investors are unlikely to be aware of IITs.[492] On this basis, it is reasonable to assume that such decision-makers do not internalise the constraints of IIT protections when

[488] Wagner (n 154) 467.

[489] text to n 301.

[490] Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 607.

[491] Text to n 303.

[492] Coe and Rubins (n 472) 599.

evaluating the adoption of new governmental measures.[493] However, this an important area for further study. Hypotheses about the extent of internalisation effects must be open to testing and revision if and when future evidence comes to light.

4.6.4.4 Empirical testing hypotheses of regulatory chill I: uncertainty and chilling

This section examines the hypothesis that states are not dissuaded from adopting or maintaining measures that may not have given rise to liability under IITs. It is more difficult to find evidence to test this assumption. Among Tienhaara's fourteen detailed case studies of foreign investment and environmental regulation, there are three cases in which IIT protections arguably affected a state's regulatory conduct. One of these is *SD Myers*, which has been considered in the previous section.

The other two cases Tienhaara examines are the notorious *Ethyl Corp v Canada* and the less well known events surrounding Vannessa Ventures dealings with the Costa Rican environmental authorities. The facts in Ethyl concerned a Canadian government measure that banned the import of gasoline additive MMT on environmental grounds. The Canadian government reversed the ban after an arbitral tribunal ruled it had jurisdiction to hear a claim brought by Ethyl challenging the measure under NAFTA's Chapter 11.[494] It seems the Canadian government's decision to abandon the measure was partly motivated by a Canadian court ruling that the measure breached Canada's Agreement on Internal Trade.[495] Nevertheless, the fact that Canada choose to make settlement payments to Ethyl,[496] rather than scrap the measure and contest the arbitral claim on the merits, suggests that IIT protections did play some role in the government's decision.

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[493] cf Schneiderman (n 94) 114.

[494] Tienhaara (n 154) 157.

[495] ibid.

[496] ibid.

The case of Vannessa Ventures related to a mining concession owned by the company. In 2003, the Costa Rican environmental agency declined to approve Vannessa Venture's environmental impact assessment, a step necessary for it to commence open-pit mining.[497] This denial of approval reflected a change in policy on open pit-mining, although it was disputed whether Vannessa Ventures had held the necessary environmental permits to commence mining before the change in policy.[498] The environmental agency maintained its position throughout two years of domestic court proceedings. Then, only two months after the investor initiated arbitration proceedings, and with issues still before the Constitutional Court, it approved Vannessa Venture's proposal.[499] Although Tienhaara uncovers no direct evidence that the threat of arbitration caused the agency to issue the approval, the timing of events suggests that it played some role. (In 2010, five years after these events, a Costa Rican court ruled that the concession awarded to Vannessa was inconsistent with Costa Rican law.[500] This decision is now the subject of a dispute. These events do not detract from the conclusion that the earlier actions of the environmental agency constituted a case of regulatory chill.)

Gross describes a similar set of circumstance in Indonesia. Although information on the case is limited, it appears that the Indonesia government had legislated to ban open-pit mining.[501] A number of mining companies with undeveloped exploration contracts threatened international arbitration, relying – on Gross's reading of the facts – on the protections of

[497] ibid 239.

[498] ibid 238.

[499] ibid 239.

[500] Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 624.

[501] Stuart Gross, 'Inordinate Chill' (2003) 24 Michigan Journal of International Law 893, 894.

applicable IITs.[502] Six months later the government revoked the measure. The Environment Minister linked the change of policy to the threat of arbitration.[503]

In all three of these cases there seems to have been some chilling effect. The more difficult question is whether the abandoned measures were likely to have been permissible. In each it seems that the state had an arguable case on the merits, suggesting that either uncertainty about the implications of IIT protections or concern about the costs of arbitration played a role. The facts of *Ethyl* bear some similarity to a later case, *Methanex v US*, in which the US successfully defended a ban on a gasoline additive on environmental grounds.[504] This suggests that the abandoned measure may have been permissible. The Costa Rican and Indonesian cases raise more difficult issues. Arbitral decisions concerning denial of permits to use land in a certain way do not lay down any bright line tests. However, several arbitral awards appear to accept that states are entitled to refuse permission for land to be used in a certain way, so long as fair administrative processes are followed and the state has not made any assurances to the contrary to the investor.[505] This suggests that the strength of both Costa Rica's and Indonesia's defences would have depended on the scope of permission held by and the assurances made to mining companies before the changes in policy. In Gross's view, the Indonesian measure would not have given rise to liability had the case proceeded to arbitration.[506]

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[502] ibid 897.

[503] ibid 895.

[504] David Gantz, 'Potential Conflict between Investor Rights and Environmental Regulation under NAFTA's Chapter 11' (2001) 33 George Washington International law Review 651, 665.

[505] *Tecmed* (n 484) [173]; *Metalclad* (n 271) [97].

[506] Gross (n 501) 960.

Schneiderman presents two additional case studies (his third case study is *Ethyl*) which examine the interaction of IIT protections and governmental decision-making.[507] The first is the Canadian attempt to introduce legislation requiring plain packaging for cigarettes in 1994. This measure was abandoned after the Canadian Supreme Court found similar legislation to be unconstitutional. [508] Opposition of foreign investors based on IIT protections does not appear to have been significant in that decision. Prior to the ruling of unconstitutionality the relevant legislative committee had recommended the adoption of the measure despite tobacco companies' claims the measure violated IIT protections.[509] The second is the case of South African affirmative action policies in the mining sector, which were the subject of arbitration in *Piero Foresti v South Africa*.[510] Schneiderman claims that the case shows that 'South Africa's internal policy options will have been shaped by the external environment for the promotion and protection of foreign investment.'[511] His own evidence does not support this claim. He does not present any evidence to suggest that concern about liability under IITs influenced the development and drafting of South Africa's Black Economic Empowerment policies. Although there is some suggestion that the pressure of arbitral proceedings expedited the claimants dealings with the South African authorities,[512] South Africa both maintained and applied its affirmative action policies despite the claim, which was ultimately abandoned by the claimants.[513]

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[507] Schneiderman (n 94) 129.

[508] ibid 128.

[509] ibid.

[510] *Piero Foresti, Laura de Carli and others v Republic of South Africa* ICSID Case No ARB(AF)/07/1, Award, 4 August 2010.

[511] Schneiderman (n 94) 157.

[512] *Piero Foresti* (n 510) [118].

[513] ibid [117].

There are other examples in which decision-makers have maintained permissible environmental and human rights measures, despite opposition from foreign investors. In *Methanex v US, Glamis Gold v US, Chemtura v Canada* and *Lucchetti v Peru* the respective respondent states maintained the impugned measures throughout arbitration proceedings and ultimately avoided liability.[514] It seems that Uruguayan government is maintaining its restrictions on tobacco marketing,[515] measures that are now the subject of a claim in *Philip Morris Products v Uruguay.*[516] Similarly, Australia has introduced plain packaging requirements for tobacco that are now the subject of an IIT claim brought by Philip Morris.[517]

Overall, it is clear that foreign investors' invocation of IIT protections does not always lead to the chilling of the governmental measure subject to challenge. There are a number of cases in which states have maintained measures in the face of arbitral proceedings initiated by investors. That said, there is some evidence to suggest that IIT protections do, on occasion, dissuade states from maintaining measures that may not have given rise to liability. There is certainly enough evidence to throw doubt on the hypothesis that any chilling is limited only to measures that would breach IIT protections. This is all the more so given that, as noted in the previous section, there is likely to be a bias in available evidence, with cases in which regulation is not chilled being more likely to come to public attention.

While the evidence is complex and inconclusive, the implications of the theory that uncertainty increases regulatory chill are relatively clear: levels of protection that provide

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[514] *Methanex* (n 470); *Glamis Gold* (n 483); *Chemtura v Canada* Award, 2 August 2010; *Lucchetti* (n 209).

[515] Luke Eric Peterson, 'ICSID panels convened in disputes over Uruguay's tobacco policies, Venezuelan airport concession, Polish health-care venture, and Hungarian energy investment' (2011) <http:// www.iareporter.com/articles/20110330> accessed 28 April 2011.

[516] *Philip Morris Products SA (Switzerland) v Oriental Republic of Uruguay* ICSID Case No ARB/10/7.

[517] Luke Eric Peterson, 'Analysis: Australian defense strategy puts emphasis on timing of Philip Morris's corporate structuring moves, claims "abuse" of investment treaty' (2011) IA Reporter <http://ezproxy.ouls.ox.ac.uk:4998/articles/20111231_8> accessed 24 January 2012.

decision-makers with greater certainty about how the protection would apply to governmental measures will reduce the chilling of permissible measures. IIT protections that give arbitrators unstructured discretions, or that turn on *ex post* judgments that decision-makers cannot easily predict when considering the adoption of measures prospectively are likely to be associated with greater uncertainty and greater chilling of measures that would have been permissible.[518]

4.6.5 The possibility of more complex effects on government decision-making

The previous sections have considered two relatively simple causal hypotheses relating to the likely effect of different levels of IIT protection on government decision-making. They highlighted the difficulties in drawing inferences from current evidence, even with respect to these relatively simple hypotheses. Conscious, perhaps, of these limitations, the academic literature on regulatory chill has not given a great deal of attention to the possibility that IIT protections may have more complex effects on government behaviour. However, these difficulties in testing more complex hypotheses do not mean that more complex causal mechanisms are not at work, or that the possibility of such mechanisms should be ignored. This section considers two more complex hypotheses: that international scrutiny of government decision-making improves the effectiveness of environmental or human rights-inspired measures; and that the extent to which states are held liable for environmental or human rights-inspired measures affects the extent to which they cooperate in addressing such concerns in other fora on the international plane.

In other contexts, the argument has been made that international scrutiny of government decision-making improves the effectiveness of measures ultimately adopted. For example, Zahrnt argues that international review, through the institutions of the WTO, of the

[518] Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 615.

process by which states adopt sanitary and phyto-sanitary measures can improve domestic decision-making.[519] The causal assumption implicit in this argument is that institutional arrangements that force government decision-makers to reflect more carefully on the justifications for a given measure improve the effectiveness of the measures ultimately adopted in realising their objectives. However, in other contexts, the opposite argument has been made – that review of government decision-making by judicial bodies can encourage 'defensive practice' that makes government measures less effective.[520]

Whether the possibility of review by an international arbitral tribunal improves, reduces or has no impact on the effectiveness of human rights and environmental measures adopted is an empirical question, one for which there is little available evidence. While the argument that international review improves government decision-making offers a justification for the availability of investor-state arbitration, its implications for questions relating to the desirable level of substantive protection to be provided in IITs are less clear. To the extent that the argument speaks to the level of protection that should be available, it implies that arbitral review of government conduct should focus on whether the procedures by which a measure was adopted were rational and fair,[521] rather than the question of whether the measure affected the interests of the foreign investor.

The second hypothesis concerns the likely impact of different levels of protection on the behaviour of the state as an international legal actor. On the one hand, one might argue that if a state is held liable for measures perceived to constitute legitimate environmental or human rights regulation, it would strengthen the hand of domestic constituencies that oppose

[519] Valentin Zahrnt 'Transparency of complex regulation: how should WTO trade policy reviews deal with sanitary and phytosanitary policies?' (2011) 10 World Trade Review 217, 237.

[520] Marsh (n 302) 19.

[521] Zahrnt (n 519) 237.

international cooperation and assert the primacy of the domestic political priorities. There is at least some indirect evidence of reactions of this sort, in the behaviour of countries reacting to controversial cases brought under IITs by withdrawing from the ICSID Convention.[522]

On the other hand, one might argue that if a state were required to compensate a foreign investor following the introduction of an environment or human right-inspired measure that is perceived as legitimate, the state may be encouraged to seek clearer international agreement on the legitimacy of such measures. This argument is consistent some economic theories of why states cooperate, in that changes in the perceived pay-offs of cooperation are thought to drive state behaviour.[523] One difficulty with this argument is that the environmental and human rights measures that have been the subject of IITs claims do not appear to be matters that are amenable to international standard setting – for example, the question of when it is legitimate for a state to unilaterally alter the terms of a water concession contract to promote universal access to water,[524] or the question of when it is legitimate to require back-filling as an environmental condition for the award of a mining permit.[525] Moreover, there is little empirical evidence for the proposition that state liability under IITs encourages international cooperation. As yet no systematic study has been undertaken to examine the effect of adverse arbitral awards on states' subsequent international behaviour in the field of human rights and environmental standard setting.

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[522] Including Bolivia, Mary Helen Mourra, 'The Conflicts and Controversies in Latin American Treaty-Based Disputes' in Mary Helen Mourra (ed), Latin American Investment Treaty Arbitration (Kluwer 2007) 63; and Ecuador ICSID 'Ecuador Submits a Notice under Article 71 of the ICSID Convention' (2009) <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=OpenPage&PageType=AnnouncementsFrame&FromPage=NewsReleases&pageName=Announcement20> accessed 23 January 2012.

[523] Dunoff and Trachtman (n 223) 14.

[524] *Suez and Vivendi* (n 137).

[525] *Glamis* (n 483).

Overall, existing empirical evidence is inadequate to test hypotheses about these more complex causal dynamics. Identifying these gaps in existing empirical research is a useful exercise, in that it helps define a future empirical research agenda into the impacts of IIT protections on government decision-making. Nevertheless, uncertainty about the probability of complex impacts that have not been debated in the existing literature and for which there is not yet any empirical evidence, should not preclude the consideration of likely consequences that have been debated in the existing literature, for which there is significant relevant evidence and which are underpinned a coherent – albeit simplified – causal account of the way in which legal rules influence government decision-making.

4.6.6 The consequence of regulatory chill for human rights and environmental conservation

The previous sections tested hypotheses about the extent of regulatory chill likely to follow from the adoption of different levels of IIT protection. The final issue is the likely impact of the chilling of environmental and human rights-inspired measures on the realisation of human rights and the protection of the environment. Assessing this impact requires a further set of inferences contrasting the likely effect on the realisation of human rights and environmental protection of regulations that are not adopted (or not maintained) as a result of regulatory chill with the effect of regulations introduced. This section begins with a survey of the environment and human rights-inspired measures that have been the subject of past IIT claims. It then traces the effect that the chilling of such measures would have on the realisation of human rights and environmental protection.

4.6.6.1 What sorts of environmental and human rights measures have been subject of IIT claims

A range of measures purporting to pursue environmental and human rights objectives have been the subject of IIT claims. In the field of human rights, investors have challenged

measures: banning the use or sale of products purportedly harmful to human health (right to health);[526] regulating the marketing of tobacco (right to health);[527] altering water supply contracts, purportedly to ensure access to drinking water (right to water);[528] promoting affirmative action to redress past institutionalised racial discrimination (right to equality);[529] and failing to control or prevent public demonstrations, which the investor contended had become violent (right to freedom of assembly).[530] Of the claims that have led to an award on the merits, the respondent state was successful in each case, save those relating to the unilateral alteration of water supply contracts.

In the field of environmental protection, investors have challenged: measures imposing environmental conditions on the award of mining permits;[531] measures imposing environmental conditions on the award of permits to operate hazardous waste facilities;[532] measures imposing environmental conditions on the award of permits to operate coal power stations;[533] judgments of domestic courts holding the investor liable for pollution allegedly caused by the investor (the investor argues that the state had released the investor from

[526] *Chemtura* (n 514); *Methanex* (n 470).

[527] *Philip Morris v Uruguay* (n 516); Peterson, 'Analysis: Australian defense strategy puts emphasis on timing of Philip Morris's corporate structuring moves, claims "abuse" of investment treaty' (n 517).

[528] *Suez and Vivendi* (n137); *Vivendi II* (n 485); *Biwater* (n 485).

[529] *Piero Foresti* (n 510).

[530] *Tecmed* (n 484) [177]; *Plama* (n 165) [236].

[531] *Glamis* (n 483); *PacRim v El Salvador* ICSID Case No ARB/09/12, Notice of Arbitration 30 April 2009 [77].

[532] *Tecmed* (n 484).

[533] Peterson, 'Parties in *Vattenfall v Germany* Case Suspend Proceedings' (n 270).

liability);[534] and measures expropriating the investor's land for the purpose of establishing an environmental reserve.[535]

Environmental measures have also been cited by host state in cases where it appears that the purported environmental objective was merely a pretext. For example, in *Metalclad* an executive decree establishing a conservation reserve for the preservation of a rare cactus, which prevented the operation of the investor's hazardous waste facility, was made only after other attempts to halt the construction of the facility had failed;[536] and in *SD Myers*, a ban on the transboundary movement of PCB waste, purportedly justified by environmental concerns about the safe transport of the waste, greatly *increased* the distance the waste had to be transported. However, these cases are in the minority. In most cases disagreement between the investor and the state has related to the question of whether the impugned measure constitutes an unjustified interference with the investor's interests in the pursuit of a valid objectives,[537] rather than the question of whether the objective was a pretext.

This survey supports two important conclusions. The first is that a wide variety of environment and human rights-inspired measures have been the subject of IIT claims in the past. This is important because it suggests that, when negotiating IITs, states may not be able to foresee the particular measures that may be the subject of IIT claims in the future. Rather, states will need to make prospective judgements based on a more general assessment of the way in which given levels of IIT protection are likely to influence the exercise of regulatory power. The second is that several cases in which the state has asserted an environmental or

[534] *Chevron v Ecuador (II)* Notice of Arbitration 23 September 2009.

[535] *Santa Elena* (n 74).

[536] *Metalclad* (n 271).

[537] *Tecmed* (n 484).

human rights justification for its actions have proved controversial.[538] However, in most cases, it is clear that the measure to which the investor objected would have made some contribution to the realisation of the environmental or human rights objective purportedly pursued.[539] If measures of this sort were chilled, it would have a negative effect on realisation of human rights and on environmental conservation.

4.6.6.2 What is the likely consequence of chilling

To the extent that environmental and human rights-inspired measures are likely to be chilled if a given level of IIT protection were adopted – an issue examined in detail in previous sections – such chilling is likely to have negative impacts for the realisation of human rights and environmental objectives. This inference does not rest on the assumption that the measures abandoned would have been the most effective way to achieve a particular human rights or environmental objective. Rather, it is based on the assumption that the abandoned measures would have been somewhat effective in achieving their purported objectives, an assumption that is consistent with a review of the measures that have been challenged by investors.

Chilling is unlikely to lead to improvements in the realisation of human rights or environmental conservation. The effectiveness of measures to realise human rights is a function of their consequences for a wide range of individuals; the effectiveness of measures to protect the environment is a function of their achievement of non-economic conservation objectives. While the economic interests of foreign investors may occasionally coincide with these objectives,[540] they are not representative of them. Reluctance on the part of decision-

[538] *Metalclad* (n 271); *SD Myers* (n 487).

[539] *Santa Elena* (n 74); *Tecmed* (n 484) and, generally, text to n 517.

[540] For example, in late 2009 Graeme Hall Sanctuary filed a notice of dispute under the Canada-Barbados BIT against Barbados. The prospective claimant alleged that Barbados had violated the BIT by failing to enforce its

makers to interfere with the economic interests of foreign investors is unlikely to lead to the realisation of these objectives.

4.6.7 Summary of regulatory chill

The examination of regulatory chill can be summarised in the following propositions:

1. The extent of regulatory chill is likely to vary between decision-makers within and between states.
2. There is little evidence to suggest that concern about liability under IIT protections is internalised in decision-making processes, thereby chilling the adoption of governmental measures. Evidence of chilling consists primarily of cases in which states have not maintained measures in the face of opposition from foreign investors based on IITs protections.
3. Both critics and supporters of IITs assume that states are less likely to maintain measures that give rise to liability under IIT protections than to maintain measures that do not. Existing evidence is consistent with this proposition. On this basis, levels of protection in which a state is liable for environmental or human rights-inspired measures are likely to lead to greater chilling than levels of protection in which the environmental or human right characteristics of a measure weigh against liability.
4. It is reasonable to assume that levels of protections that provide greater certainty to decision-makers reduce the chilling of measures that would not have given rise to liability. However, there is not yet sufficient evidence to verify this hypothesis.
5. Chilling effects are unlikely to have positive consequences for the realisation of human right and environmental conservation. The extent of any negative

own environmental laws. Elizabeth Whitsitt, 'Claimant seeks enforcement of environmental laws in notice of dispute alleging expropriation of Barbadian nature sanctuary' [2010] Investment Treaty News 4.

consequences associated with a given level of protection is likely to depend on the structure of liability under the protection in question.

4.7 Consequences for the rule of law

The protections contained in IITs may also affect host states' legal institutions; the formal characteristics of the laws promulgated by them; and the procedures by which they are applied. Raz's seminal work on the rule of law proposes three desirable characteristics of laws and a further five desirable characteristics of the legal institutions that enforce them.[541] The formal characteristics that law should possess are that it be: prospective, open and clear; relatively stable; and that the making of particular (subsidiary) laws should be guided by open clear and stable general rules.[542] The principles governing legal institutions include that: the judiciary should be independent; the courts should be accessible; and natural justice should be observed.[543] This thesis adopts the Razian conception of the rule of law and takes as given that the qualities he identifies are intrinsically normatively desirable.[544] There is also a body of social scientific scholarship that links the strength of the rule of law within a state to the state's economic prosperity.[545] While noting this research, the thesis proceeds on the basis that greater compliance with the rule of law would be desirable even if it were not associated with the attainment of other, instrumental objectives.

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[541] Raz (n 113) 202.

[542] ibid 198.

[543] ibid 200.

[544] In Raz's work the normative desirability of the rule of law is grounded in individual autonomy. Respect for the rule of law allows an individual to know the law and organise her life according to it, ibid 198.

[545] See, Sachiko Morita and Durwood Zaelke, 'Rule of Law, Good Governance and Sustainable Development' (2005) 16 <http://www.inece.org/conference/7/vol1/05_Sachiko_Zaelke.pdf> accessed 26 July 2010, whose definition of the rule of law approximates the Razian conception. However, other empirical studies that purport to establish a connection between the rule of law and economic development use statistics that do not reflect the Razian conception, eg Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 'Governance Matters VIII' (2009) 77 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424591> accessed 26 July 2010.

Other scholars have argued for broader conceptions of the rule of law that address the substantive content of law.[546] For example, some have argued that, to comply with the rule of law, law must protect human rights;[547] or that it must be reasonable and proportionate.[548] For the purpose of this thesis, it is unnecessary to resolve debates about whether the Razian conception is unduly narrow. The consequences of IIT protections for the substantive content of host-governmental regulations are examined above, in terms of efficiency and the realisation of human rights and environmental conservation. The purpose of this section is to identify the consequences of IIT protections on the formal, institutional and procedural qualities of host states' legal systems – their Razian characteristics – that are not assessed in previous sections.

4.7.1 Theory and evidence on IIT protections and the rule of law

While the concept of the rule of law has been invoked in debates about IITs with increasing frequency over the past five years, there have been relatively few attempts to link the level of protection provided in IITs to the rule of law. One notable exception is in the work of Schill, who has argued that the FET provisions of IITs can be understood as 'an embodiment of the rule of law'.[549] In his article, the argument that certain arbitral awards have articulated principles that are consistent with the rule of law is developed in great detail.[550] However, the central causal proposition – that requiring host states to compensate investors for breaching

[546] Craig (n 115) 467.

[547] Thomas Bingham, *The Rule of Law* (Allen Lane 2010) 66.

[548] Schill, 'Fair and Equitable Treatment' (n 22) 169.

[549] Schill, 'Fair and Equitable Treatment' (n 22) 155; similarly Vandevelde, 'A Unified Theory of Fair and Equitable Treatment' (n 186) 48.

[550] In contrast, Chapter 5 of this thesis argues that arbitral jurisprudence on the FET standard cannot be explained and justified by a coherent set of doctrinal principles, as contended by Schill.

such principles will encourage states to act consistently with the rule of law – is assumed, rather than justified or proved.[551]

This section begins by reviewing existing empirical evidence on the impact of IITs on the extent to which states respect the rule of law; it then reviews theories relating to the likely impact of IITs on respect for the rule of law; finally, it examines the causal hypothesis implicit in Schill's argument. Prior to considering the likely effect of adopting different levels of protection in IIT for the rule of law, it is important to distinguish academic debate about investor-state arbitration and the rule of law.

4.7.1.1 Distinguishing debate about investor-state arbitration and the rule of law

Most discussion of the relationship between IITs and the rule of law centres on the institutions and procedures of investor-state arbitration. Many of the references to the rule of law are somewhat opaque, but they seem to reflect a belief that that the resolution of investment disputes by legal adjudication, rather than by negotiation or political pressure, is more consistent with the rule of law.[552] In this vein, Vandevelde states that 'the rule of law triumphs when sovereign governments commit themselves to legal processes and honor those processes'.[553] Van Harten rejects this view, arguing that arbitration is inconsistent with the rule of law because '[t]here can be no rule of law without an independent judiciary.'[554] Another context in which the rule of law has been invoked is to justify tribunals' decisions to follow earlier awards that are not binding on them.[555]

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[551] Schill, 'Fair and Equitable Treatment' (n 22) 181.

[552] Sampliner (n 79) 41; UNCTAD, *Development Implications* (n 6) 5; Paulsson (n 125) 2.

[553] Vandevelde, *Bilateral Investment Treaties* (n 114) 119. Similarly, Brower and Steven (n 175) 202.

[554] van Harten, *Investment Treaty Arbitration and Public Law* (n 19) 174.

[555] *Saipem v People's Republic of Bangladesh* ICSID Case No ARB/05/07, Decision on Jurisdiction and Recommendation on Provisional Measures, 21 March 2007 [67].

For the purpose of this thesis, it is not necessary to determine the extent to which the resolution of international investment disputes through compulsory investor-state arbitration is consistent with the rule of law, or to determine whether the rule of law requires a *de facto* doctrine of precedent. This thesis focuses on the level of substantive protection provided by IITs. Discussion of the rule of law is only of interest to the extent that it draws attention to the consequences that are likely to flow from adopting differing levels of protection, taking the institution of investor-state arbitration as given. Such consequences would depend on the capacity of IIT protections to induce changes in host states' domestic legal systems.

4.7.2 Empirical evidence of the impact of IITs on the rule of law in host states

The impact (if any) of IITs on the extent to which states respect the rule of law is an empirical question of exceeding complexity. Thus far, two attempts have been made to investigate some of these issues empirically. Ginsburg's regression analysis suggests that signing a BIT has a minor negative impact on the rule of law in signatory states.[556] Aranguri's regression analysis suggests that signing a BIT has little impact on the rule of law in signatory states and that a foreign investor's successful claim under a BIT has a negative, but statistically insignificant, impact on the rule of law.[557] There are several challenges associated with empirical work of this sort, including the reduction of 'rule of law' to a single metric and controlling for endogeneity.[558] A great deal more evidence is needed before any reliable conclusion can be drawn.

[556] ibid 121.

[557] Cesar Aranguri, 'The Effect of BITs on Regulatory Quality and the Rule of Law in Developing Countries' (2010) 29 <www.iilj.org/research/documents/IF2010-11.Aranguri.1.pdf> accessed 20 April 2011.

[558] There are particularly acute endogeneity concerns with respect to the Aranguri study, which does not attempt to control for changes in governance that may make the signing of a BIT more likely.

4.7.3 Theories on the relationship between IITs and respect for the rule of law

Only a handful of scholars have reflected on the relationship between IITs and improvements in the rule of law in host states. Their arguments fall into two opposing camps. One view is that IITs, and international arbitration under them, complement domestic legal systems. According to this theory, arbitration under IITs demonstrates the benefits of impartial legal institutions, thereby engendering domestic support in host states for reforms that promote the rule of law.[559] The alternate view is that IITs entrench weakness in domestic legal systems.[560] This theory runs that, by allowing foreign investors to exit the domestic legal regime, international investment arbitration removes an important constituency that might advocate for greater respect for the law and stronger legal institutions at the domestic level.

Both theories are based on the argument that the ability of foreign investors to access compulsory investor-state arbitration will have consequences for the respect for the rule of law in host states. As such, both theories suggest that the extent of any impact on the rule of law in particular states would vary with the presence (absence) of provisions in IITs that govern the ability of investors to exit the domestic legal system and access arbitration: exhaustion of local remedies requirements, fork-in-the-road clauses, umbrella clauses and the like. Neither theory implies an obvious relationship between the level of substantive protection adopted in IITs and consequences for the rule of law.

4.7.4 Formulating hypotheses about the relationship between levels of IIT protection and the rule of law

The causal assumption implicit in Schill's argument is that protections under which a state is more likely to be found liable when its conduct does not respect the rule of law are more

[559] Franck, 'Foreign Direct Investment' (n 120) 367; similarly, Wälde and Weiler (n 176) text to fn 22.

[560] Ginsburg (n 120) 119.

likely to encourage respect for the rule of law.[561] This hypothesis rests on the three further assumptions that: lawmakers and decision-makers are aware of IITs; are concerned to avoid liability under them; and know that greater compliance with Razian principles will reduce their likelihood of breaching IITs. The hypothesis is consistent with economic theories of the state, in which the monetary incentives are thought to influence decision-making,[562] and is also consistent with the assumptions about the likely extent of regulatory chill that are implicit in the arguments of both critics and supporters of IITs.[563] Because this hypothesis is theoretically coherent, intuitively plausible, and generally accepted it constitutes a useful starting point for inferences about the likely consequences of different levels of protection for the rule of law. However, in the absence of evidence to test this proposition, it remains a tentative hypothesis vulnerable to revision in light of future evidence.

Two further qualifications should also be added to this hypothesis. The first relies on the distinction between 'threat' and 'internalisation' effects of IIT protections, developed in the analysis of regulatory chill.[564] When an investor threatens litigation under an IIT, any procedural unfairness or unfairness resulting from application of laws that are unpublicised, unclear and unstable of which the investor complains is likely to have occurred. While a host state may reverse a substantive decision to avoid the risk of liability to an investor, it cannot undo procedural unfairness which the investor has already suffered. As such, threat effects are probably less significant in tracing the consequences of IIT protections for the rule of law than they are in the analysis of regulatory chill. The consequences (if any) of different levels

[561] Schill, 'Fair and Equitable Treatment' (n 22) 181

[562] Blume, Rubinfeld and Shapiro, 'The Taking of Land' (n 67) 90

[563] Schill, 'Do Investment Treaties Chill Unilateral State Regulation to Mitigate Climate Change?' (n 262) 477; Vandevelde, *Bilateral Investment Treaties* (n 114) 107; Tienhaara, 'Regulatory chill and the threat of arbitration' (n 262) 626.

[564] This distinction is introduced above, in text to n 474.

of protections for the degree of respect for the rule of law primarily depend on the assumption that the host state's internalisation of the liability rules contained in IITs. This chapter has argued that 'internalisation' effects on government behaviour are likely to be less significant than 'threat' effects on government behaviour.[565]

The second qualification concerns the institutional complexity of the host state – specifically, the impact of IITs protections on the conduct of the judiciary in host states. Questions about the impact of international legal rules on the conduct of domestic courts raise highly specific and profoundly complex empirical questions. Domestic courts are subject to unique institutional constraints in that they are bound to apply law. This thesis does not attempt to draw any inferences about the impact of IIT protections on the behaviour of the judiciary in host states. Accordingly, in subsequent chapters, it does not seek to evaluate different levels of protection so far as they concern the liability of the state for judicial conduct. The hypothesis proposed in this section is a proposition limited to the behaviour of the non-judicial organs of host states.

4.7.5 Summary of rule of law

The examination of the rule of law can be summarised in the following two propositions:

1. Little is known about the impact of the substantive protections of IITs on the respect for the rule of law in host states.
2. One reasonable hypothesis is that protections in which a state's liability depends on whether a measure taken by the executive or legislative arms of the state is consistent with Razian norms are more likely to encourage respect for the rule of law.
3. Inferring the likely effect of IIT protections on the judicial systems of host states raises highly complex empirical issues that this thesis does not attempt to address.

[565] see text to n 493.

4.8 The boundaries of the normative framework

The previous sections of this chapter constitute a framework for identifying and evaluating the likely consequences of different levels of IIT protection. These consequences can be divided into five categories, namely the effect of IIT protections on: efficiency; the distribution of economic costs and benefits; flows of FDI into host states; the realisation of human rights and environmental conservation in host states; and respect for the rule of law in host states. In the course of this analysis, the thesis explained how the availability of private insurance, the possibility of negotiating contractual protections with the host state and the taxation policies of the host state relate to the inferences drawn. In the interests of clarity, this section briefly explains why further categories of consequences are unnecessary. This argument is divided into two parts. First, this section shows why the consequences of IIT protections, as seen from the perspective of a host state or home state, are adequately addressed within the five-category framework. Second, this section shows that some supposed consequences of IITs are unconnected to the consequences of IIT protections.

4.8.1 The impact of IIT protections on host and on home states

An alternative way to begin an examination of the consequences of IIT protections would be to adopt the perspectives of host states and of home states. A state-centric framework for understanding consequences is implicit in some examinations of why states sign IITs.[566] The consequences of IIT protections for host states are normally understood as loss of sovereignty and increased inflows of FDI. The consequences for home states are normally understood in terms of the protection of the interests of foreign investors, relying on the, often unstated, assumption that home states' interests are aligned with those of their investors abroad.[567]

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[566] Guzman, 'Why LDCs Sign Treaties that Hurt Them' (n 53) 643.

[567] See, Kenneth Vandevelde, 'The BIT Program' (1992) 86 American Society of International Law Proceedings 532, 534.

These consequences of IIT protections, as framed by a state-centric perspective, are fully accounted for by the normative framework developed in this chapter. Concerns about host states' loss of sovereignty can be understood as concerns that IITs may leave states unable to enact measures that are normatively desirable.[568] These concerns are addressed within the normative framework in terms of efficiency and regulatory chill. Moreover, the benefit of FDI flows to host states is addressed directly through inclusion as an element of the framework. The economic costs and benefits of alternative levels of protection for foreign investor were examined in the analysis of distributive consequences. Any benefits of IIT protections to home states – for example, increases in revenue from corporate taxation or greater dividends to home state shareholders – follow indirectly from these consequences.

4.8.2 Rationales for IITs that are unrelated to the consequences of IIT protections

There are two further arguments in the literature that seek to justify IITs on the basis of their consequences for the relationship between signatory states. It is useful to explain why these rationales for signing IITs, even if they were to be empirically verified, are not relevant to debate about the desirable level of IIT protection. The first such rationale is that IITs remove international investment disputes from the ambit of inter-governmental politics, thereby contributing to friendly relations between states.[569] For the purposes of this thesis, it is sufficient to note that it is the institution of investor-state arbitration that provides purported independence from inter-governmental politics.[570] Once a dispute is subject to arbitration under an IIT it has been removed from the ambit of inter-governmental politics. Differences

[568] Yannaca-Small (n 125) 2. Text to n 124.

[569] Daniela Caruso, 'Private Law and State-Making in the Age of Globalization' (2006) 39 New York University Journal of International Law and Politics 1, 53.

[570] Ibrahim Shihata, 'Towards a greater Depoliticization of Investment Disputes' (1986) 1 ICSID Review - FILJ 1, 24.

in the level of substantive protection to be applied in arbitral proceedings do not jeopardise the achievement of this objective.

A second, related, rationale for international economic agreements, potentially including IITs, is that they strengthen diplomatic ties and promote cooperation between states.[571] In the context of IITs, the argument would be that the process of negotiating and signing these treaties improves diplomatic relations, with positive consequences for other aspects of the relationship between signatory states. This rationale may go some way towards explaining why states continue to sign IITs, in spite of ambivalent evidence about their effectiveness in attracting FDI. However, states can achieve the benefits of cooperation engendered by the negotiation and agreement process regardless of the level of protection they choose to confer within such treaties.

4.9 Conclusion

This chapter has constructed a framework for inferring and evaluating the likely consequences of adopting different levels of IIT protection. These consequences can be divided into five categories, the effect of IIT protections on: efficiency; the distribution of economic costs and benefits; flows of FDI into host states; the realisation of human rights and environmental conservation in host states; and respect for the rule of law in host states. More detailed inferences regarding the likely effect of different levels of protections on each category of consequences are summarised in point form at the end of each section. It is unnecessary to restate these inferences here. These specific inferences form the basis for the evaluation of different levels of protection that might be adopted in Chapters 7.

[571] Robert Wai, 'Transnational Liftoff and Juridical Touchdown' (2002) 40 Columbia Journal of Transnational Law 209, 224.

Without wishing to pre-empt the application of this framework in Chapter 7, it is worth drawing attention to two general insights that emerge from the evaluative framework. First, the economic justifications for IIT protections are weaker than might be assumed. IIT protections do not appear to have a significant effect on FDI flows. Whether they increase economic efficiency will depend on the level of protection provided, however, protections that are more favourable to the interests of foreign investors are not, self-evidently, associated with net economic benefits.

Second, a lack of evidence inhibits a full understanding of the consequences of IIT protections for the realisation of human rights, environmental conservation and respect for the rule of law in host states. Any generalisations relating to the realisation of these objectives must be cautious, relying on evidence to the extent it exists, and with theoretical arguments complementing evidence where possible. Proceeding on this basis, it seems likely that levels of protection in which liability turns on an examination of whether the government's conduct in question is consistent with the realisation of human rights, environmental conservation and the rule of law are more likely to lead to the realisation of these objectives than protections in which liability turns on the degree of interference with the interests of the investor.

Chapter 7 explores the implications of these general insights, and the other specific insights of this chapter, in greater detail. Having constructed a framework for evaluating different levels of protection in this chapter, the next task for the thesis is to identify alternative levels of protection that might be adopted in future IITs. Chapter 5 and Chapter 6 show that the FET and indirect expropriation provisions of IITs have been interpreted as entailing different levels of protection. The levels of protection implied by different arbitral decisions are sketched as models, each of which constitutes an option that might be explicitly adopted in future IITs.

Chapter 5 Fair and Equitable Treatment

5.1 Introduction

The use of the phrase 'fair and equitable' in the field of foreign investment protection seems to originate from the 1948 Havana Charter of the International Trade Organisation (ITO), an institution that never came into existence. Article 11(2) conferred power on the ITO to promote international agreements 'to ensure just and equitable treatment for the enterprise, skills, capital, arts and technology from one Member county to another.'[572] Soon afterwards, the obligation to provide 'fair and equitable treatment' to both foreigners and their property began to appear in US treaties on Friendship Commerce and Navigation (FCN), the precursors to modern IITs.[573] Specific obligations to provide fair and equitable treatment to foreign property were then included in the 1959 Abs-Shawcross Draft Convention on Investments Abroad and the 1967 Organization for Economic Cooperation and Development (OECD) Draft Convention on the Protection of Foreign Property.[574] It appears that the obligation passed into the BIT practice of states from these draft multilateral instruments.[575] The obligation to accord foreign investment fair and equitable treatment (FET) is now contained in the majority of IITs. Under many of the remaining IITs – those that do not contain a FET provision – a foreign investor could rely on a most-favoured nation (MFN) clause to import the standard from another treaty.[576]

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[572] Havana Charter (24 March 1948) 62 UNTS 30 para 143.

[573] Catherine Yannaca-Small, *Fair and Equitable Treatment Standard in International Investment Law* (Working Papers on International Investment, 2004) 4.

[574] Herman Abs and Hartley Shawcross, 'Draft Convention on Investments Abroad' 9 Journal of Public Law 116, art 1; OECD Draft Convention on the Protection of Foreign Property 1967 (1968) 7 ILM 117 art 1(a).

[575] Stephen Vasciannie, 'The Fair and Equitable Treatment Standard in International Investment Law and Practice' (1999) 70 British Yearbook of International Law 99, 112.

[576] Newcombe and Paradell (n 152) 255; *MTD v Chile* ICSID Case No ARB/01/7, Award, 21 May 2004 [104]; *Bayindir v Islamic Republic of Pakistan* ICSID Case No ARB/03/29, Award, 27 August 2009 [157].

The FET standard has risen to prominence remarkably swiftly. Prior to 2000, no publicly available arbitral award applied the FET standard.[577] Since this time, investors have alleged breach of FET in almost every claim brought under an IIT.[578] Two of the standard's characteristics are particularly important in understanding its popularity among claimants. The first is that a government may breach the standard even if a foreign investment is treated as well (or better) than local investment.[579] The second is that an exceedingly broad range of government conduct can be challenged for failure to meet the standard.[580] During the past decade, breach of FET is also the claim with which foreign investors have the best record of success in arbitral proceedings.[581] For all these reasons, commentators now suggest that the standard is the most significant protection contained in IITs.[582]

The obligation to provide 'fair and equitable treatment' could be read as requiring both fair treatment and equitable treatment. However, arbitral awards are unanimous in reading the two words as a single standard.[583] The legal content of this standard is not immediately obvious. Decisions are replete with observations that the wording of the

[577] Rudolf Dolzer, 'Fair and Equitable Treatment' (2005) 39 The International Lawyer 87, 88.

[578] Salacuse (n 32) 218.

[579] The FET standard is often described as a 'non-contingent standard'; eg Vasciannie (n 575) 105. While there is no doubt that a state may breach the standard without discriminating against a foreign investment, some tribunals have suggested that discriminatory conduct will also breach the standard, for example *Parkerings-Compagniet AS v Lithuania* ICSID Case No ARB/05/8, Award, 11 September 2007 [287].

[580] Dolzer, 'Fair and Equitable Treatment' (n 577) 90.

[581] Dolzer and Schreuer (n 64) 119; Lucy Reed and Daina Bray, 'Fair and Equitable Treatment' in Arthur Rovine (ed), *Contemporary Issues in International Arbitration and Mediation* (Martinus Nijhoff 2008).

[582] Dolzer and Schreuer (n 64) 119; Newcombe and Paradell (n 152) 255.

[583] Dolzer and Schreuer (n 64) 123.

standard is 'somewhat vague' and 'none too clear and precise.'[584] Indeed, some commentators have gone so far as to argue that FET is:

> [A]n intentionally vague term, designed to give adjudicators a quasi-legislative authority to articulate a variety of rules necessary to achieve the treaty's object and purpose in particular disputes.[585]

Regardless of whether treaty-makers intended to confer such broad authority on tribunals, it is clear that the text of IITs does not provide a great deal of guidance about what distinguishes fair and equitable treatment from unfair and inequitable treatment.

This chapter seeks to understand and elucidate the different ways in which tribunals have interpreted the FET standard of IITs. I propose a basic taxonomy of the 'elements' of the FET standard and then employ an inductive methodology to locate arbitral reasoning within that taxonomy. The taxonomy divides decisions between those dealing with the protection of the legitimate expectations of the investor; decisions reviewing governmental conduct on procedural grounds; and decisions reviewing governmental conduct on substantive grounds. While this taxonomy is original, it should not prove controversial. Almost every commentator has argued that FET comprises a number of elements which include the protection of the investor's legitimate expectations and other doctrines providing for the procedural and substantive review of governmental conduct.[586] These elements function as quasi-independent components of the FET standard, in that a state can be found liable for breach of one element of the standard without any suggestion that it has breached the other elements.

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[584] *CMS Gas v Republic of Argentina* ICSID Case No ARB 01/08, Final Award, 12 May 2005 [273]; *Enron Corporation v Argentine Republic* ICSID Case No ARB/01/3, Award, 22 May 2007 [256].

[585] Charles H. Brower, 'Structure, Legitimacy, and NAFTA's Investment Chapter' (2003) 36 Vanderbilt Journal of Transnational Law 37, 63.

[586] eg Newcombe and Paradell (n 152) 275; Dolzer and Schreuer (n 64) 133; Barnali Choudhury, 'Defining Fair and Equitable Treatment in International Investment Law' (2005) 6 The Journal of World Investment and Trade 297, 316.

Notwithstanding the use of common terminology – for example, reference to an investor's legitimate expectations – I show that tribunals give markedly different legal content to the various elements of FET. I argue that arbitral decisions can be further divided into distinct interpretations of each element. Each interpretation is sketched as a model level of protection, which might be explicitly adopted in future IITs. This analysis and classification is, in itself, an original contribution of this thesis. This classification also provides the basis for Chapter 7, which evaluates these different levels of protection derived from interpretations of the FET standard through the application of the normative framework developed in Chapter 4. This thesis does not seek to determine which interpretations of the FET standard are 'correct' on doctrinal grounds.

This chapter comprises seven substantive sections. Section 5.2 examines the differences in the wording of FET provisions between IITs and argues that this thesis is justified in treating arbitral decisions that interpret differently-worded FET provisions as parts of a single body of jurisprudence. Section 5.3 explains and justifies the parameters of this chapter – this chapter does not address decisions in which liability under the FET standard stems from the fact that treatment is discriminatory, or in bad faith, or a denial of justice. Section 5.4 argues that the remaining FET decisions can be divided into those concerned with three distinct elements of the FET standard: protection of an investor's legitimate expectations; procedural review of government conduct; and substantive review of government conduct. Section 5.5 examines tribunals' interpretation of the protection of legitimate expectations under the FET standard; Section 5.6 considers interpretation of the procedural review element; and Section 5.7 considers interpretation of the substantive review element. Each of these three sections argues that arbitral reasoning coalesces around a number of distinct interpretations of the element of FET in question.

5.2 Foundational doctrinal issues in the interpretation of the FET standard

5.2.1 The drafting of FET clauses

Although the obligation of states to provide 'fair and equitable treatment' to foreign investment is common to most IITs, there is significant variation in the way in which treaty clauses containing this provision are drafted. Following the classification proposed by Dolzer and Schreuer, three basic patterns of drafting can be identified.[587] First, the FET standard can be a freestanding obligation. For example, Article 3(1) of the China-Myanmar BIT provides simply that '[i]nvestments of investors of each Contracting Party shall all the time be accorded fair and equitable treatment in the territory of the other Contracting Party.'[588] Second, the FET standard can be included in a clause that contains a number of standards of treatment. For example, Article 10(1) of the ECT reads:

> Each Contracting Party shall, in accordance with the provision of this Treaty, encourage and create stable, equitable favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal.[589]

Third, the FET standard can be identified as a standard that is required by 'international law', where the basic obligation is to comply with an international law standard. For example, Article 1105(1) of NAFTA provides that '[e]ach Party shall accord

[587] Dolzer and Schreuer (n 64) 121.

[588] China-Myanmar BIT (12 December 2001).

[589] ECT (n 10).

investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.'[590]

These three basic drafting patterns could be further disaggregated to highlight nuances in treaty language. In a 2007 study UNCTAD proposed dividing FET provisions into seven model types.[591] The UNCTAD taxonomy draws attention to the different standards that are sometimes included alongside FET within a single treaty clause, and to different ways in which clauses refer to international law. A particularly important distinction is between treaties that require treatment according to international law including FET, and those that require FET including treatment '[i]n no case ... less favourable than that required by international law'.[592] The latter terminology leaves open the possibility that the FET standard may require treatment beyond that required by international law, whereas the former does not.[593] Of course, questions remain as to what standard of treatment is required by international law and whether 'international law' refers only to customary international law.

5.2.2 FET: customary international law minimum standard or autonomous treaty standard?

Most academic analysis of textual nuance in FET provisions focuses on the significance of treaty text in determining whether a particular provision embodies the customary international law minimum standard for the treatment of aliens (IMS – international minimum standard); or whether it imposes an autonomous, presumably more exacting, treaty

[590] NAFTA (n 9).

[591] UNCTAD, *Bilateral Investment Treaties 1995-2006, Trends in Investment Rule-Making* (United Nations 2007) 28.

[592] ECT (n 10) art 10(1).

[593] Vandevelde, *Bilateral Investment Treaties* (n 114) 191; *Lemire v Ukraine (II)* ICSID Case No ARB/06/18, Decision on Jurisdiction and Liability, 14 January 2010 [253].

standard.[594] This debate is also central to arbitral analysis of textual variation. Often, an investor alleging breach of FET will argue that the FET provision in the applicable IIT imposes an autonomous standard, while the respondent state will argue that it imposes the IMS.[595] Thus, the issue put to the tribunal is the implication of a specific textual formulation for the determination of whether a given FET provision simply refers back to the IMS.[596] This determination is analytically prior to subsequent questions about the standard of conduct required by the IMS or by FET, to the extent it is construed as an autonomous standard.

The practical significance of the debate is that, historically, the IMS has been understood as a relatively lenient standard. The point of departure for discussion of the IMS is often the *Neer Claim*,[597] which found that:

> [T]he treatment of an alien, in order to constitute an international delinquency should amount to an outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognise its insufficiency.[598]

(However, it is important to note that in *Neer* the Tribunal was reviewing Mexico's investigation of the murder of a foreign national, not the way in which a foreign investment had been treated.)[599]

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[594] Meg Kinnear, 'The Continuing Development of the Fair and Equitable Treatment' in Andrea Bjorklund, Ian Laird and Sergey Ripinsky (eds), *Investment Treaty Law: Current Issues III* (British Institute of International and Comparative Law 2009) 215.

[595] Ioana Tudor, *The Fair and Equitable Treatment Standard in the International Law of Foreign Investment* (Oxford University Press 2008) 140, 142.

[596] eg *Siemens v Argentina* ICSID Case No ARB/02/8, Award, 6 February 2007 [289].

[597] Yannaca-Small, *FET Standard in International Investment Law* (n 573) fn 37.

[598] *Neer Claim*, Mexico-US General Claims Commission, RIAA, IV 60.

[599] *Mondev International v United States of America* ICSID Case No ARB(AF)/99/2, Award, 11 October 2002 [115].

The debate about the relationship between FET and the IMS has been going on for some time,[600] and great deal of intellectual energy has been expended on it. The ascendant view is that, unless the text of the IIT in question specifically provides otherwise, FET is an autonomous standard.[601] However, a minority view – buttressed by some supporting state practice – remains that FET provisions should always be understood as references to the IMS.[602] This thesis does not attempt to resolve this doctrinal debate. Instead, this section provides a brief overview of tribunals' discussion of the relationship between treaty text, the FET standard and the IMS. The purpose of this review is to ascertain the extent to which tribunals' interpretation of the legal content of FET provisions is predetermined by their view of whether the FET provision in question embodies the IMS.

5.2.2.1 The IMS vs autonomous standard debate in arbitral awards

When confronted with IITs in which the FET provision is not explicitly limited to international law, few tribunals have found that FET refers to the IMS. In *Genin v Estonia*, a case sometimes cited as authority for the proposition that FET does refer to the IMS,[603] the Tribunal was confronted with a BIT that provided for FET including treatment not 'less favourable than that required by international law.'[604] The Tribunal described the FET standard as 'an "international minimum standard" that is separate from domestic law' but did not make a specific finding that the FET standard referred to *the* customary international law

[600] See early remarks in, F. A. Mann, 'British Treaties for the Promotion and Protection of Investments' (1981) 52 British Yearbook of International Law 241, 244.

[601] Vasciannie (n 575) 144; Dolzer and Schreuer (n 64) 124; Salacuse (n 32) 228; Peter Muchlinski, *Multinational Enterprises and the Law* (2nd edn, Oxford University Press 2007) 635.

[602] Montt (n 23) 306. For review of supporting state practice, see Newcombe and Paradell (n 152) 268.

[603] Salacuse (n 32) 223.

[604] *Alex Genin v Estonia* ICSID Case No ARB/99/2, Award, 25 June 2001 [13].

minimum standard.[605] The Tribunal in *MCI Power v Ecuador* went further. Interpreting a similarly worded FET provision, it held that FET obliges states to provide the standard of treatment required by international law, and that 'international law' meant 'customary international law'.[606]

Most tribunals have come to the opposite conclusion – that, absent express textual linkage, the FET standard is not limited to the IMS. The relevant paragraph of the decision in *Bayindir v Pakistan* is representative of these decisions, and is worth quoting in full:

> As an initial matter, the Tribunal notes that Article 4 of the Pakistan-Switzerland BIT makes no reference to general international law. However, as already mentioned, customary international law and decisions of other tribunals may assist in the interpretation of this provision. This is particularly apposite here given that Article 4(2) of the Pakistan-Switzerland BIT simply states a general obligation of fair and equitable treatment. The Tribunal must therefore set forth the meaning of such a general obligation.[607]

Other decisions could be cited to similar effect.[608] Moreover, at least one tribunal has interpreted treaty language that might have been read as limiting FET to the IMS as imposing an autonomous standard. The Tribunal in *Vivendi v Argentina (II)* found that an obligation to provide 'fair and equitable treatment according to the principles of international law' set a standard that was more demanding than international law.[609]

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[605] ibid [367]; *Saluka* (n 165) [295].

[606] *MCI Power v Ecuador* ICSID Case No ARB/03/6, Award, 31 July 2007 [369]. Similarly, *Lauder v Czech Republic* Final Award, 3 September 2001 [292]; *Suez, Sociedad General de Aguas de Barcelona and InterAgua Servicios Integrales del Agua v Argentina* ICSID Case No ARB/03/17, Separate Opinion of Arbitrator Pedro Nikken, 30 July 2010 [6]-[18].

[607] *Bayindir* (n 576) [176].

[608] Including, *Enron* (n 584) [258]; *National Grid v Argentina* Award, 3 November 2008 [167]; *MTD* (n 576) [110]-[112]; *Plama* (n 165) [163]; *PSEG Global v Turkey* ICSID Case No ARB/02/5, Award, 19 January 2007 [239]; *Sempra Energy v Argentina* ICSID Case No ARB/02/16, Award, 28 September 2007 [302]; *Suez and Vivendi* (n 137) [177]-[179]; *Tecmed* (n 484) [155].

[609] *Vivendi II* (n 485) [7.4.1], [7.4.6].

Of the decisions that find that the applicable FET provision is autonomous, many go on to observe that the autonomous standard's content is 'not materially different from the content of the minimum standard of treatment in customary international law.'[610] The purported equivalence results from the fact that customary international law has evolved over time to a point where the IMS approximates FET,[611] rather than the 'watering down' of the treaty standard to the level of the IMS. According to these decisions, the evolution of the IMS has been driven, in part, by the proliferation of IITs. IIT provisions, along with arbitral awards interpreting them, are the primary evidence cited for evolution.[612] Proceeding on the assumption that the two standards are similar, at least two more tribunals have found it unnecessary to determine whether the FET provisions in question were autonomous or whether they were references to the IMS.[613]

The situation in cases where tribunals have confronted treaty language where FET is explicitly limited to international law is more complex. At the present time, claims of this sort have only arisen under Art 1105(1) of NAFTA, which demands 'treatment in accordance with international law, including fair and equitable treatment'. Early decisions under Art 1105(1) took the view that this provision did not equate FET with *customary* international law.[614] However, In the context of NAFTA, the FET-IMS debate has now been resolved. In June 2001, the Tribunal in *Pope & Talbot v Canada* issued a partial award in which it

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[610] *Biwater* (n 485) [592]. Similarly, *Azurix v Argentina* ICSID Case No ARB/01/12, Award, 14 July 2006 [361]; *CMS* (n 584) [282]-[284]; *Occidental* (n 204) [190]; *Rumeli Telekom v Kazakhstan* ICSID Case No ARB/05/16, Award, 29 July 2008 [610]; *Saluka* (n 165) [291]; *Siemens* (n 596) [299].

[611] *Azurix* (n 610) [361]-[372].

[612] ibid.

[613] *Duke Energy v Ecuador* ICISD Case No ARB/04/19, Award, 18 August 2008 [333]-[337]; *BG Group v Argentina* Final Award, 27 December 2007 [291].

[614] *SD Myers* (n 487) [264]; similarly, *Metalclad* (n 271) [76]; although this portion of the *Metalclad* decision was overturned on review, *The United Mexican States v Metalclad Corporation* 2001 BCSC 664, 2 May 2001 [68]-[72].

interpreted Art 1105(1) as including obligations of fair treatment – 'fairness elements' – that were 'additive to the requirements of international law.'[615] The Tribunal justified its 'additive' interpretation by reference to the NAFTA parties' BITs with other states.[616] In response the three NAFTA parties used the powers conferred on the NAFTA Free Trade Commission (FTC) to issue a binding interpretation of Art 1105(1), which affirms that Art 1105(1) does not go beyond the IMS.[617] The statement reads:

> B. Minimum Standard of Treatment in Accordance with International Law
>
> 1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.
>
> 2. The concepts of 'fair and equitable treatment' and 'full protection and security' do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.
>
> 3. A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).[618]

Subsequent tribunals have accepted that they are bound by the FTC interpretation of Art 1105(1).[619] BITs and free trade agreements (FTAs) signed by the US and Canada since 2002 also contain, within the treaty text, statements based on the FTC interpretation.[620] Disputes under these treaties are yet to come to arbitration.

Questions remain as to the standard of conduct required under the IMS, and how this standard relates to autonomous FET obligations in other IITs. In answering the former

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[615] *Pope & Talbot v Canada* Interim Award, 26 June 2000 [110].

[616] ibid [110]-[118].

[617] NAFTA (n 9) art 1131(2).

[618] Notes of Interpretation of Certain Chapter 11 Provisions (NAFTA Free Trade Commission, 31 July 2001).

[619] *Mondev* (n 599) [120]; *ADF Group v USA* ICSID Case No ARB(AF)/00/1, Award, 9 January 2003 [177].

[620] Dolzer and Schreuer (n 64) 125.

question, the majority of NAFTA tribunals have begun by observing that the IMS is an evolving standard, concurring with the view of tribunals under other IITs. The Tribunal in *Mondev v US* noted a development in 'both the substantive and procedural rights of the individual in international law' and the broad spread of IITs containing FET provisions.[621] It concluded that 'the content of the minimum standard today cannot be limited to the content of customary international law as recognised in arbitral decisions in the 1920s.'[622] Similar statements have been made by many other NAFTA tribunals.[623] Only the Tribunal in *Glamis v US* has found that the IMS had not evolved since the 1920s – or, more precisely, that, while conduct that may once have seemed acceptable might now be deemed outrageous, the legal standard itself could still only be breached by conduct that was 'outrageous', egregious' or 'shocking'.[624]

Most NAFTA tribunals have found it unnecessary to determine whether the IMS has evolved to such an extent that it has converged with the standard set by autonomous FET provisions.[625] It seems that only two tribunals have made findings squarely on the point. In *Merrill & Ring* the Tribunal held that the two standards were equivalent, arguing that to allow any difference in the scope of the IMS and autonomous FET provisions 'would be to countenance an unacceptable double standard.'[626] In contrast, the Tribunal in *Glamis*, having

[621] *Mondev* (n 599) [116], [117].

[622] *ADF* (n 619) [123].

[623] ibid [179]; *Waste Management v Mexico (II)* ICSID Case No ARB(AF)/00/3, Final Award, 30 April 2004, (2004) 43 ILM 967 [92]; *GAMI Investments v Mexico* Final Award, 15 November 2004 [95]; *Merrill & Ring Forestry v Canada* Award, 31 March 2010 [205]-[213]; *Chemtura* (n 514) [121].

[624] *Glamis Gold* (n 514) [616].

[625] eg *ADF* (n 619) [183].

[626] *Merrill & Ring* (n 623) [213].

adopted a restrictive interpretation of the IMS, found that it was bound to ignore the decisions of tribunals interpreting autonomous FET provisions.[627]

A further dimension to the FET-IMS debate is the claim that fair and equitable treatment is a general principle of law.[628] The argument is that general principles of law are a legitimate source of guidance in construing treaty provisions, as they are among the 'relevant rules of international law applicable in the relations between the parties' referred to by article 31 of the VCLT.[629] As such, tribunals might be justified in interpreting differently-worded treaty provisions according to the common, underlying general principles which they embody.[630]

For the purpose of this thesis it is not necessary to resolve the doctrinal question of whether FET is a general principle of law and, if so, what the implications for treaty interpretation would be. It is sufficient to observe that the view that FET is a general principle of law has not yet taken hold among tribunals.[631] Only Professor Wälde's dissent in *Thunderbird v Mexico* endorses this view and, even then, only with respect to protection of the investor's legitimate expectations.[632] Thus, the foundational question for this chapter

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[627] *Glamis Gold* (n 514) [611].

[628] Tudor (n 595) 103; similarly, Schill, 'Fair and Equitable Treatment' (n 22) 175.

[629] Montt (n 23) 304; *Golder v the United Kingdom* Judgment 21 February 1975, ECHR Series A (1975) No 18 [35].

[630] Stephan Schill, 'Book Reviews' (2009) 20 European Journal of International Law 229, 237.

[631] The relationship between customary international law and general principles of law is briefly discussed in *ADF* (n 619) [185]; *Enron* (n 584) [257].

[632] *International Thunderbird Gaming v United Mexican States* Separate Opinion, 26 January 2006 [28]-[30]. Similarly, Elizabeth Snodgrass, 'Protecting Investors' Legitimate Expectations' (2006) 21 ICSID Review - Foreign Investment Law Journal 1, 11; see also, *Merrill & Ring* (n 623) [187] for a more qualified reference to general principles of law in the interpretation of the FET standard.

remains the relationship between treaty text, the IMS and the interpretation of FET provisions.[633]

5.2.3 Is it legitimate to abstract from textual variation in FET provisions in an analysis of FET decisions?

The question of whether it is permissible to analyse decisions interpreting different FET provisions as a group, or as uniquely tied to a particular treaty text, is particularly pressing when it comes to NAFTA. FET in NAFTA refers to the IMS, whereas most tribunals beyond NAFTA regard FET as an autonomous standard. Although some academic commentary does treat NAFTA and non-NAFTA IIT decisions as separate lines of jurisprudence,[634] most text writers treat all IIT decisions on FET as a single body of cases.[635] In this chapter, I follow the dominant practice in academic writing – treating all FET decisions as a single body of cases, while explicitly noting the cases that were decided under NAFTA. This section explains why such an abstraction from textual variation is justified.

The primary justification for treating FET decisions as a group is the high degree of consensus among tribunals that FET embodies a common set of legal elements – protection of the investor's legitimate expectations and protection from procedural unfairness, substantive unreasonableness and denial of justice in the courts of a host state.[636] This consensus in the elements of the standard exists, notwithstanding differences in treaty text.

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[633] Newcombe and Paradell (n 152) 271 fn 192.

[634] Rudolf Dolzer and André von Walter, 'Fair and Equitable Treatment - Lines of Jurisprudence on Customary Law' in Federico Ortino, Audley Sheppard and Hugo Warner (eds), *Investment Treaty Law: Current Issues Volume 1* (British Institute of International and Comparative Law 2006) 103; Kinnear (n 594) 223.

[635] Tudor (n 595) 154; Newcombe and Paradell (n 152) 275; Todd Grierson-Weiler and Ian Laird, 'Standards of Treatment' in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law* (Oxford University Press 2008) 272; Dolzer and Schreuer (n 64) 133; Salacuse (n 32) 228; Campbell McLachlan, Laurence Shore and Matthew Weiniger, *International Investment Arbitration* (Oxford University Press 2007) 226; Vandevelde, *Bilateral Investment Treaties* (n 114) 194.

[636] Dolzer and Schreuer (n 64) 133.

Relative agreement as to the common legal elements of FET makes it sensible to talk of *an* FET standard and provides a basis for the comparison of the reasoning of different tribunals interpreting this standard.[637]

In this vein, Vandevelde goes so far as to assert that:

> International arbitral awards have been uniform in their interpretation of the standard, regardless of the context in which it appears, whether alone, combined with other general absolute standards of treatment, linked with non-discrimination standards, or linked with customary international law.[638]

His statement is too sweeping. In subsequent sections, this chapter shows that there is considerable variation in the way in which tribunals have understood the meaning of various elements of the FET standard. However, for the purposes of this thesis, the crucial point is that *the pattern of variation in interpretation of FET provisions is not predetermined by nuances in treaty text, nor by tribunals' views about the relationship between FET and the IMS.*

A second justification for treating FET decisions as a group is that NAFTA contains a MFN clause. Other tribunals have interpreted similarly-worded MFN clauses in a way that permits a claimant to rely on an FET clause contained in a BIT between the respondent state and a third state.[639] Both Mexico and the US have signed BITs that post-date the entry into force of NAFTA and contain FET provisions that are not explicitly tied to the IMS.[640] It is certainly arguable that a NAFTA claimant could have recourse to one of these autonomous

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[637] Note the similarity between the analysis of legitimate expectations in the NAFTA case, *International Thunderbird Gaming v United Mexican States* Arbitral Award, 26 January 2006 [147]; and the US-Argentina BIT case, *Enron* (n 584) [262].

[638] Vandevelde, *Bilateral Investment Treaties* (n 114) 194.

[639] *MTD* (n 576) [104]; *Bayindir* (n 576) [157].

[640] US-Estonia BIT (19 April 1994) art 2(3); Netherlands-Mexico BIT (13 May 1998) art 3(1). On the other hand, Canada's BITs from the mid-1990s up to the redrafting of the Canadian model BIT in 2004 require 'fair and equitable treatment in accordance with the principles of international law'; eg Canada-Lebanon BIT (11 April 1997) art 2(2)a.

FET clauses via NAFTA's MFN clause, rendering any difference in the FET standard between NAFTA and other IITs meaningless. Surprisingly, it seems that the NAFTA MFN clause has only been invoked once in this manner. In that case, the Tribunal was able to avoid the issue, on the grounds that it would make no difference to the outcome of the case.[641]

A third justification for treating FET decisions as a group is the convergence of the IMS with autonomous understandings of FET. Recall that, among NAFTA decisions, the predominant view is that the IMS is evolving and that this evolution is, to some extent, influenced by the proliferation of IITs and arbitral decision under them.[642] Tribunals outside NAFTA agree with this position, and a significant number of them suggest that the IMS has evolved to the point where it is equivalent with autonomous FET treaty provisions.[643] These observations are not sufficient to definitively resolve debate about the relationship between FET and the IMS, but they do highlight the close relationship between decisions interpreting different FET provisions.

A final justification for treating all FET decisions as a single group is the cross-citation of decisions of tribunals constituted under different treaties. Tudor, for example, suggests that NAFTA and BIT tribunals freely cite each other's decisions.[644] This is not strictly true. Many tribunals under other IITs do cite NAFTA decisions. However, when interpreting and applying Art 1105(1), only three of the sixteen decided NAFTA cases cite the decision of an investor-state arbitration from beyond NAFTA.[645] Nevertheless, the regular citation of NAFTA decisions in non-NAFTA awards is both a cause and evidence of the co-

[641] *Chemtura* (n 514) [235].

[642] Text to n 623.

[643] Text to n 610.

[644] Tudor (n 595) 154.

[645] Author's citation count, noting, *Chemtura* (n 514) [137]; *GAMI* (n 623) [88]; *Thunderbird* (n 637) [194].

evolution of FET jurisprudence. This observation buttresses the decision to treat FET decisions as single group.

5.2.4 Other standards equivalent to the FET standard

Although use of the term 'fair and equitable treatment' is remarkably widespread, occasionally IITs employ some other synonym for the word 'fair'. Tribunals have not given these variations legal significance. In *Parkerings v Lithuania* the Tribunal confronted a treaty provision that required 'equitable and reasonable treatment'. It found that this provision was identical to the FET standard.[646] In the consolidated claims of *Suez, InterAgua and AWG v Argentina* the Tribunal was required to apply the French-Argentine BIT. The treaty provided – in its French and Spanish language version respectively – for 'un traitement juste et équitable' and 'un tratamiento justo y equitativo'.[647] The decision (rendered in English) translated the treaty provision as an obligation of 'just and equitable treatment'. It went on to hold that there was no difference in meaning between this provision and the FET standard.[648] The analysis in this chapter includes arbitral decisions interpreting treaty terms that tribunals understand to be *identical* to FET.

5.3 Parameters: the scope of the FET standard and the limitations of this chapter

The FET standard allows investors to challenge the treatment of its investment by any arm of the host state's government in a wide range of circumstances. Arbitral tribunals have developed different doctrines to deal with different categories of cases under the standard.

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[646] *Parkerings* (n 579) [278].

[647] *Suez, Sociedad General de Aguas de Barcelona and InterAgua Servicios Integrales del Agua v Argentine Republic* ICSID Case No ARB/03/17, Decision on Liability, 30 July 2010 [176]; *Suez and Vivendi* (n 137) [183].

[648] *Suez and InterAgua* (n 647) [176].

This chapter does not address the full range of circumstances in which the FET standard has been applied. Three sets of decisions are excluded: those dealing with treatment of foreign investment by a host state's judicial system; those dealing with liability under the FET standard for discriminatory conduct; and those dealing with situations where a state has embarked on a deliberate and coordinated campaign to ruin an investment. These excluded circumstances correspond roughly with those that would be covered by the doctrines of denial of justice, national treatment and bad faith respectively. Each of these limitations excludes only a small minority of FET cases. Setting these parameters allows this chapter to go into greater depth in analysing the remaining cases – those in which claimants have argued that a state's legislative or administrative actions have breached FET, understood as an objective, non-contingent standard. This section provides a brief description of each of these parameters and explains why, in the context of this thesis, these limitations are justified.

5.3.1 Conduct of a state's judicial institutions that breaches the FET standard

There is no doubt that the treatment of foreign investment by a host state's judicial system can breach the FET standard. In determining whether the improper conduct of judicial proceedings constitutes a breach of FET, tribunals have looked to the customary international law principles governing the treatment of aliens by foreign courts – the principles of denial of justice.[649] IIT tribunals agree that, with respect to the conduct of judicial proceedings, the FET standard does not go beyond what is required by the doctrine of denial of justice.[650] This position is also endorsed in academic commentary.[651]

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[649] On the principles of denial of justice generally, see Jan Paulsson, *Denial of Justice in International Law* (Cambridge University Press 2005).

[650] *Mondev* (n 599) [126]; *Jan de Nul and Dredging International v Egypt* ICSID Case No ARB/04/13, Award, 6 November 2008 [188]; *Víctor Pey Casado v Chile* ICSID Case No ARB/98/2, Laudo, 8 May 2008 [657].

[651] Tudor (n 595) 160; Salacuse (n 32) 241; Dolzer and Schreuer (n 64) 142.

The principles of denial of justice are highly specific to the treatment of a foreigner by the judicial institutions of a host state. A full exposition of these principles would require a review of customary international law on the subject, going beyond the decisions of IIT tribunals. Moreover, a normative evaluation of state liability for judicial action would raise different issues to a normative evaluation of state liability for legislative or administrative action. For both reasons, I exclude analysis and evaluation of the interpretation of the principles of denial of justice, so as to focus in greater detail on state liability for legislative and administrative action.

5.3.2 Conduct that breaches the FET standard because it is discriminatory

A government may breach the FET standard even if a foreign investment is treated as well (or better) than local investment.[652] However, many tribunals have observed that discrimination against a foreign investment may also constitute a breach of the FET standard.[653] Some tribunals even go far as to suggest that discriminatory treatment of an investment will always breach the FET standard.[654]

The assessment of whether impugned treatment is discriminatory is seldom decisive in the application of the FET standard. Two decisions serve to illustrate this point. In *Eureko v Poland* the investor challenged the failure of the Polish government to sell it a second tranche of shares in a Polish bank, as had been agreed in a privatisation contract between the investor and the government. In *Eastern Sugar v Czech Republic* the investor challenged the reallocation of the national sugar production quota that followed the European Union's (EU) reduction of the Czech national quota; the reallocation reduced Eastern Sugar's quota by

[652] Vasciannie (n 575) 105.

[653] *Saluka* (n 165) [292];*Waste Management II* (n 623) [98]; cf *Grand River Enterprises v USA* Award, 12 January 2011 [208].

[654] *Parkerings* (n 579) [287]; *CMS* (n 584) [290]; *Noble Ventures v Romania* ICSID Case No ARB/01/11, Award, 12 October 2005 [182].

more than the entire reduction in the national quota.[655] In both cases, the Tribunals accepted that it was likely that the governments' actions had been motivated by nationalist or protectionist sentiment.[656] However, the reasoning of these decisions confirms that these inferences of discriminatory motive were not decisive. In *Eureko*, liability rested on the fact that the state had repudiated the fundamental terms of the privatisation contract with the investor;[657] in *Eastern Sugar*, liability was based on the fact that the state could not provide *any* rational justification for the way in which it had reallocated the sugar quota.[658]

There are only two cases in which treatment that arguably would have satisfied the FET standard (in the absence of discrimination) was found to breach the standard on account of being discriminatory. One of these cases is *SD Myers*, in which the Tribunal simply stated that breach of the NAFTA national treatment provision entailed breach of the FET standard on the facts in question.[659] The subsequent FTC Interpretation of Article 1105(1) makes it unlikely that the case would now be decided in the same way.[660] The other case is *Saluka v Czech Republic*, a case distinguished by the fact that the Tribunal subsumed its discussion of breach of the national treatment provision of the BIT into its analysis of FET.[661]

It is easy to understand why discrimination is seldom determinative of FET cases. Most IITs contain a specific provision dealing with discriminatory treatment – either a national treatment clause, or a provision prohibiting 'arbitrary or discriminatory measures', or

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[655] *Eastern Sugar v The Czech Republic* SCC No 088/2004, Partial Award, 27 March 2007 [291].

[656] *Eureko v Republic of Poland* Partial Award 19 August 2005 [233]; *Eastern Sugar* (n 655) [314], [338].

[657] *Eureko* (n 656) [232]-[235].

[658] *Eastern Sugar* (n 655) [333]-[337].

[659] *SD Myers* (n 487) [264], [268].

[660] Notes of Interpretation art 1105 (n 618).

[661] *Saluka* (n 165) [283].

sometimes both.[662] An investor that was able to show that it had suffered discrimination would be able to succeed in a claim under one of these provisions. An additional basis of liability under the FET standard would then be of little consequence. This was the situation in *SD Myers*. On the other hand, an investor that was unable to show that it had suffered discrimination, often due to difficulties in identifying a similarly situated comparator, would be left to advance its claim under the non-contingent elements of the FET standard. This was the situation in the *Parkerings v Lithuania*, *Loewen v US*, *BG v Argentina* and *CMS v Argentina* awards.[663]

As allegations of discrimination are seldom decisive in FET cases, this chapter is justified in omitting analysis of discriminatory treatment, so as to focus on the non-contingent elements of the FET standard. State liability for discriminatory treatment under IITs remains an important issue; and there is not yet consensus among tribunals about the interpretation of non-discrimination obligations.[664] Space constraints of the DPhil format mean that this thesis does not include an additional chapter dealing with treaty provisions that address discriminatory treatment. This absent chapter would have discussed the finding of discriminatory treatment under the FET standard in *Saluka*, which employs a structure of reasoning derived from national treatment decisions,[665] alongside national treatment cases.

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[662] Newcombe and Paradell (n 152) 290.

[663] *Parkerings* (n 579) [290]; *Loewen v United States* ICSID Case No ARB(AF)/98/3, Award, 26 June 2003 [140]; *BG Group* (n 613) [357]; *CMS* (n 584) [295].

[664] Federico Ortino, 'Non-Discriminatory Treatment in Investment Disputes' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 351.

[665] *Saluka* (n 165) [313]; *Plama* (n 165) [184].

5.3.3 Conduct that breaches the standard because it is in bad faith

Tribunals and academic commentary agree that bad faith – governmental conduct motivated by the conscious intent to harm an investment – will breach the FET standard.[666] An allegation of bad faith requires a tribunal to examine the subjective intentions that motivate state conduct. For example, in *Tokios Tokeles v Ukraine* the claimant alleged that the Ukrainian state mounted a coordinated campaign to punish it 'for its impertinence in printing [political] materials opposed to the regime'.[667] The Tribunal accepted that such a campaign would breach the FET standard, although, on the facts, it found that the claimant was unable to establish that the state's conduct was motivated by the objective of retaliation.[668]

Tokios Tokeles is broadly representative of cases in which bad faith is alleged. While tribunals occasionally suggest that the impugned conduct of a state approaches bad faith,[669] outright findings of bad faith are rare.[670] This is due to the difficulty of proving the subjective intention of the host state.[671] To succeed in a claim based on allegations of bad faith an investor must be able to establish that the ruin of an investment was the specific *intention* of coordinated governmental conduct, rather than simply a result of government conduct.[672] Of the decisions of the past decade only *Vivendi II* could, arguably, be read as relying on a finding of bad faith.[673] Investors invariably find it easier to succeed by framing their claim

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[666] *Waste Management II* (n 623) [138].

[667] *Tokios Tokelés v Ukraine* ICSID Case No ARB/02/18, Award, 26 July 2007 [123].

[668] ibid [136].

[669] *Azurix* (n 610) [376]; *Petrobart v Kyrgyzstan* SCC Arbitration No 126/2003, Arbitral Award, 25 March 2005 76; *Vivendi II* (n 485) [7.4.19], [7.4.45]-[7.4.46].

[670] *Waste Management II* (n 623) [139]; *Bayindir* (n 576) [258]; *Chemtura* (n 514) [138].

[671] *Bayindir* (n 576) [223]; *Chemtura* (n 514) [137].

[672] *Tokios Tokelés* (n 667) [136].

[673] *Vivendi II* (n 485) [7.4.19], [7.4.45]-[7.4.46].

under some other element of the FET standard. On this basis, this chapter is justified in focusing on the elements of the FET standard that are usually legally determinative.

5.4 The elements of FET

This section presents and justifies a taxonomy of the elements of the FET standard, which provides a useful heuristic device for understanding arbitral decisions applying the FET standard. This section argues that arbitral reasoning is best understood by distinguishing decisions (or, more commonly, parts of decisions) dealing with the protection of the legitimate expectations of the investor; those reviewing governmental conduct on procedural grounds; and those reviewing governmental conduct on substantive grounds. This is a functional taxonomy in that it looks to the structure of arbitral reasoning, rather than whether arbitral decisions adopt common terminology. In arbitral reasoning these three elements function as conceptually distinct, although potentially overlapping, bases for liability of the FET standard.

Three objections might be raised to dividing FET decisions into those dealing with different elements of the standard. The first is the argument that all FET decisions can be explained by a single, unified jurisprudential theory – that is, the standard should be understood as having only one element. The second is the argument that any apparent inconsistency of legal reasoning between arbitral decisions can be explained by the different factual situations that tribunals were addressing in each case – that is, the standard should be understood as having *no* elements capable of restatement in the abstract. This section discusses and addresses each objection in turn.

5.4.1 The taxonomy of the elements of FET used in this chapter

Over the past five years, protection of the investor's legitimate expectations has emerged as the most significant element of the FET standard. The doctrine of legitimate expectations has

been sufficiently widely accepted that arbitral decisions now spend more time examining the contours of the doctrine than determining whether compliance with the doctrine is an element of FET.[674] This shared recognition of legitimate expectations as an element of FET is reflected in academic commentary.[675] Despite differences of opinion about the scope of the doctrine, the common understanding of arbitral decisions and commentators is that a breach of legitimate expectations is *sufficient* to establish liability. This thesis, like most contemporary commentary, identifies legitimate expectations as an element of the FET standard.[676] This element of the standard, and arbitral tribunals' differing understandings of it, is examined in Section 5.5.

Classifying the remaining FET decisions is more challenging. Tribunals employ a range of terminology to describe situations where a state's liability for breach of the FET standard does not rest on violation of an investor's legitimate expectations. Such terms include transparency, stability, reasonableness, consistency, arbitrariness and due process. The use of common terms is not always consistent between decisions. For example, *Maffezini v Spain* held that a Spanish state entity's withdrawal of funds from an investor's bank account breached the FET standard due to the 'lack of transparency'.[677] However, the basis of liability was that the investor had not consented to the withdrawal, not that the state had failed to disclose the withdrawal.[678] The Tribunal's reasoning is difficult to reconcile with the way in

[674] eg *Thunderbird* (n 637) [147]; *Thunderbird, Separate Opinion* (n 632) [4].

[675] Christoph Schreuer and Ursula Kriebaum, 'At What Time Must Legitimate Expectations Exist?' in Jacques Werner and Arif Hyder Ali (eds), *A Liber Amicorum* (Cameron May 2010); André von Walter, 'The Investor's Expectations in International Investment Arbitration' in August Reinisch and Christina Knahr (eds), *International Investment Law in Context* (Eleven International Publishing 2008) 173; Snodgrass (n 632) 1.

[676] Newcombe and Paradell (n 152) 279; Dolzer and Schreuer (n 64) 133; Tudor (n 595) 163.

[677] *Maffezini v The Kingdom of Spain* ICSID Case No ARB/97/7, Award, 13 November 2000 [83].

[678] ibid [75]; Vandevelde, *Bilateral Investment Treaties* (n 114) 404; Newcombe and Paradell (n 152) 293.

which the word transparency is used in other decisions.[679] Such difficulties in classifying the remaining FET decisions are reflected in academic writing. While all commentators propose some division of FET decisions, no two text writers propose an identical system of classification.[680]

In light of the range of terminology used in arbitral awards, this thesis is justified in proposing a *functional* division of the FET decisions that do not relate to an investor's legitimate expectations. This chapter distinguishes between decisions which examine whether the state has followed fair procedures and those which examine the substantive justification for government measures that have affected an investor.[681] The former category encompasses concepts such as transparency, lawfulness and procedural fairness. The latter encompasses concepts such as rationality, reasonableness and proportionality when they refer to the substance of an impugned measure. This is a functional distinction, in that it looks to the structure of reasoning that tribunals use to determine liability, rather than to whether decisions employ common terminology. For example, arbitrariness connotes procedural review when it is used to mean 'a wilful disregard of due process of law';[682] and substantive review when it is used to mean conduct 'not related to legitimate policy objectives'.[683]

Although many FET decisions involve both substantive and procedural review, it appears that both are capable of operating as independent elements of the FET standard. A

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[679] *LG&E Energy v Argentina* ICSID Case No ARB/02/1, Award, 25 July 2007 [128], arguing that transparency implies that 'all relevant legal requirements ... should be capable of being readily known'.

[680] cf Newcombe and Paradell (n 152) 275; Dolzer and Schreuer (n 64) 133; Tudor (n 595) 154; Salacuse (n 32) 218; Vandevelde, *Bilateral Investment Treaties* (n 114) 190, 234; McLachlan, Shore and Weiniger (n 635) 226.

[681] Other writers have also distinguished between procedural and substantive elements of the FET standard, among them, Vandevelde, 'A Unified theory of Fair and Equitable Treatment' (n 186) 49.

[682] *Elettronica Sicula SpA (United States of America v Italy)* Judgment of 20 July 1989, ICJ Rep 15 [128].

[683] Vandevelde, *Bilateral Investment Treaties* (n 114) 204.

completely irrational measure may breach the standard without any criticism of the procedures by which it was adopted and applied;[684] and an investor that is subjected to unfair administrative procedures may succeed in a claim even if the decisions ultimately taken by the administrative body are reasonable.[685] These two elements of the FET standard, including the degree to which they function as independent grounds of liability, are examined in Sections F and G respectively.

5.4.2 A unified jurisprudential theory of FET?

There have been various attempts to offer a unified jurisprudential theory that would explain and justify the full range of FET decisions. Some commentators suggest that the standard embodies the principle of good faith;[686] others that it embodies the rule of law.[687] Writing in dissent in *Thunderbird*, Professor Wälde argued that the standard embodies norms of good governance.[688] There are difficulties with all three theories.[689] The suggestion that FET is grounded in the principle of good faith is difficult to reconcile with the observation that 'FET is an objective standard that does not depend on whether the Respondent has proceeded in good faith or not.'[690] Theories based on the rule of law and good governance must overcome the fact that these concepts are inherently contestable. Even if a common understanding of the meaning of these concepts could be reached, they sit uneasily with awards holding that a change of government policy may breach the FET standard, even though the change was

[684] *Eastern Sugar* (n 655) [333]-[337].

[685] *Pope & Talbot, Award on the Merits* (n 163) [181].

[686] Grierson-Weiler and Laird (n 635) 272; see also, *Tecmed* (n 484) [154], [155]; *Siemens* (n 596) [308].

[687] Schill, 'Fair and Equitable Treatment' (n 22) 154; Vandevelde, 'A Unified Theory of Fair and Equitable Treatment' (n 186) 48.

[688] *Thunderbird, Separate Opinion* (n 632) [13].

[689] Newcombe and Paradell (n 152) 279.

[690] *Occidental* (n 204) [186].

made and applied through lawful procedures and was the 'result of reasoned judgment rather than simple disregard of the rule of law.'[691]

While noting these difficulties with unified jurisprudential theories, in this thesis I do not go so far as to suggest that the search for such a theory is a fruitless exercise. I make only a more modest claim, from which I draw a modest conclusion. My claim is that a generally accepted jurisprudential theory of the FET standard has yet to emerge in either arbitral decisions or academic commentary. My conclusion is that an inductive methodology can help understand and elucidate similarities and differences in the interpretation of the FET standard in decided cases. The application of inductive methodology in subsequent sections strongly supports the conclusion that the FET standard comprises a number of relatively autonomous elements. Even if a consensus were to coalesce around a general jurisprudential theory that could explain and justify all the elements of the standard, inductive methodology would still be a useful way to understand the specific legal content that tribunals give to the unifying jurisprudential principles.

5.4.3 Fact specific reasoning and the FET standard

Rather than attempt to construct a single jurisprudential theory of the FET standard, one might take a radically different approach and begin from the premise that the reasoning of each arbitral decision is specific to the factual matrix before the tribunal.[692] This understanding of the standard receives some support from arbitral awards. For example, in *Mondev* the Tribunal noted that '[a] judgment of what is fair and equitable treatment cannot be reached in the abstract; it must depend on the facts of the particular case.'[693] A doctrinal theory based on this understanding of FET might simply amount to a list of factors that

[691] *LG&E Energy* (n 679) [162].

[692] Tudor (n 595) 129.

[693] *Mondev* (n 599) [118].

suggest that the standard has been breached, a list of factors that suggest the standard has not been breached and the claim that each case involves an ad hoc exercise of characterisation.[694]

Notwithstanding that characterisation of contested facts is sometimes determinative, I submit that apparent inconsistencies in the reasoning of FET decisions are not solely attributable to factual nuances. Rather, different tribunals have different understandings of the legal content of the FET standard, differences that entail divergent patterns of legal reasoning and would lead to different decisions on an identical set of facts. These divergent patterns of reasoning are best understood by distinguishing the different elements of FET and then comparing decisions applying each element. The sections of this chapter that follow constitute a detailed and sustained argument for these propositions.

5.5 Legitimate expectations

As an element of the FET standard, the doctrine of legitimate expectations is of relatively recent origin. Its foundations are normally traced to comments made in the early arbitral awards of the twenty-first century.[695] In 2000 the Tribunal in *Metalclad* observed that the investor 'was led to believe, and did believe, that the federal and state permits allowed for the construction and operation of the landfill.'[696] Subsequent actions of the authorities to halt construction of the landfill on the grounds that an additional, municipal permit was required breached the FET standard.[697] The following year the *CME* Tribunal held that the FET standard was breached by the 'evisceration of the arrangements in reliance upon with the foreign investor was induced to invest.'[698] In 2003 the *Tecmed* Tribunal referred, for the first

[694] eg Mahnaz Malik, 'Fair and Equitable Treatment' (2009) [15] accessed 27 October 2010.

[695] eg Dolzer and Schreuer (n 64).

[696] *Metalclad* (n 271) [85].

[697] ibid [89].

[698] *CME* (n 35) [611].

time, to the protection of an investor's expectations in general terms. It stated that the FET standard requires treatment 'that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.'[699] In 2004 the *Waste Management II v Mexico* Tribunal took a somewhat more restrained view. It held that in determining whether treatment breached the FET standard it was 'relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.'[700]

By 2005 academic commentators were already arguing that the FET standard protected investors' legitimate expectations.[701] However, it was not until the *Thunderbird* decision of 2006 that an arbitral tribunal first invoked the terms 'legitimate expectations' in resolving an FET claim.[702] Since this time, the majority of FET cases have examined whether the investor's legitimate expectations were violated.[703] For investors, part of the appeal of the doctrine is that it allows a claim to be framed as an interference with a protected interest of the claimant – a legitimate expectation. Under the other elements of the FET standard, liability turns primarily on the characteristics of governmental conduct, not the extent of interference with the investor's interests. For tribunals, the utility of the doctrine seems to be that it provides a basis for resolving claims that involve a wide range of fact-patterns common in FET claims, including claims arising from changes to the general regulatory arrangements governing an investment and breaches of investor-state contracts by the host state.

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[699] *Tecmed* (n 484) [154].

[700] *Waste Management II* (n 623) [98].

[701] Dolzer, 'Fair and Equitable Treatment' (n 577) 103; Christoph Schreuer, 'Fair and Equitable Treatment in Arbitral Practice' (2005) 6 The Journal of World Investment and Trade 357, 386.

[702] *Thunderbird* (n 637) [196]; Snodgrass (n 632) 2.

[703] Author's count of publicly available arbitral awards rendered from January 2006 onwards.

Identifying the basis for state liability under the doctrine of legitimate expectations requires answers to three consecutive questions:

1. On what basis must an expectation rest to qualify for protection under the FET standard?
2. Of expectations that rest on a recognised basis, by what criteria are *legitimate* expectations identified?
3. To what extent must a claimant rely on a legitimate expectation in order to recover for its breach?

The first of these questions is the most significant, as it defines the scope of the doctrine. The way tribunals answer this question is central to understanding the different ways in which they have interpreted the doctrine. While tribunals also disagree on the second and third questions, their views on these questions are shaped by the way they answer the first question.

This section organises arbitral decisions according to the way in which they answer the first question. I submit that distinct interpretations of the doctrine of legitimate expectations have coalesced around three different answers to this question:

i) Expectations can only rest on specific rights that the investor has acquired under domestic law;
ii) In addition to i), expectations may rest on prior statements of government officials or on the regulatory framework at the time the investor made the investment;
iii) In addition to ii), expectations may rest on the business plans of the investor.

Decisions falling into the second category can be further divided into two coherent interpretations – a strict or a permissive approach – based on the way they answer the second and third questions.

Two final observations will help clarify the analysis that follows. First, the legitimate expectations of investors have been mentioned in the determination of whether given interests qualify as 'investments' for the purpose of establishing jurisdiction under an IIT; and in the determination of whether an indirect expropriation has occurred.[704] This section is limited to the protection of legitimate expectations as an element of the FET standard. Second, tribunals have occasionally held that an investor may legitimately expect the full range of treatment required by the FET standard.[705] This is doctrinally incoherent.[706] To say that an investor legitimately expects the treatment that is required by the FET standard is to make a circular argument – an argument that does not shed any light on the treatment that is required by the FET standard. The doctrine of legitimate expectation is only meaningful to the extent it gives specific content to the FET standard.[707]

5.5.1 The legal rights approach

The narrowest interpretation of the doctrine of legitimate expectations is that it protects only specific, enforceable legal rights that have vested in the investor under domestic law. Further criteria then determine the circumstances in which an interference with a particular legal right will amount to a breach of legitimate expectations. According to this interpretation, the

[704] On the definition of investment, *SPP v Egypt* Award, 20 May 1992, 3 ICSID Reports 189 [82]-[83]; *EnCana v Republic of Ecuador* Partial Dissenting Opinion, 30 December 2005 [17]-[21]; on indirect expropriation, *Azurix* (n 610) [316]; for discussion of investors' expectations beyond FET claims, von Walter (n 675) 177.

[705] *Saluka* (n 165) [303]; similarly, *Plama* (n 165) [176]; *Kardassopoulos and Fuchs v The Republic of Georgia* ICSID Case Nos ARB/05/18 and ARB/07/15, Award, 3 March 2010 [438], [441].

[706] McLachlan, Shore and Weiniger (n 635) 234.

[707] Vandevelde, *Bilateral Investment Treaties* (n 114) 235.

doctrine functions as an additional, international layer of protection for existing rights, rather than as a source of new rights. As such, this interpretation best conforms to Crawford's opinion that 'the doctrine of legitimate expectations should not be used as a substitute for the actual arrangements agreed between the parties, or as a supervening and overriding source of the applicable law.'[708]

5.5.1.1 LG&E Energy v Argentina

The first case to articulate this view of legitimate expectations was *LG&E v Argentina*. The facts of the case relate to the privatisation of the Argentine gas-distribution sector in the early 1990s. The Argentine government created a regulatory framework to make the privatisation attractive to foreign investors. This framework included guarantees that tariffs would be based on the US Producer Price Index, calculated in US dollars and adjusted twice annually.[709] These guarantees were specifically incorporated in the terms of the gas licenses awarded to the privatised entities.[710] '[T]he government could not rescind or modify the licenses without the consent of the licensees.'[711] LG&E became a shareholder in three different licensee companies.

In 2001 Argentina entered a period of deep economic and social crisis. One of the government's responses to the crisis was the January 2002 Emergency Law. The Emergency Law unilaterally modified gas licenses, removing licensees' right to the calculation of tariffs in US dollars and to the indexation of tariffs.[712] LG&E argued that the repudiation of key

[708] James Crawford, 'Treaty and Contract in Investment Arbitration' (2008) 24 Arbitration International 351, 374; similarly, *MTD v Chile* ICSID Case No ARB/1/07, Decision on Annulment, 21 March 2007 [67].

[709] *LG&E Energy* (n 679) [49].

[710] ibid [42].

[711] ibid [41].

[712] ibid [65].

rights conferred by the gas distribution licenses breached its 'basic expectations' relating to the investment and, therefore, the FET standard.[713] The claims in *CMS Gas v Argentina*, *Sempra Energy v Argentina*, *Enron v Argentina* and *BG v Argentina* were brought by other gas licensees as a result of these same events.

Addressing LG&E's FET claim, the Tribunal quoted the passages from *Tecmed* and *Waste Management II* dealing with investors' expectations.[714] It then stated its own view of the protection provided to an investor's expectations by the FET standard, as if it followed naturally from these early decisions:

> It can be said that the investor's fair expectations have the following characteristics: they are based on the conditions offered by the host State at the time of the investment; they may not be established unilaterally by one of the parties; they must exist and be enforceable by law; in the event of infringement by the host State, a duty to compensate the investor for damages arises except for those caused in the event of state of necessity; however, the investor's fair expectations cannot fail to consider parameters such as business risk or industry's regular patterns.[715]

The Tribunal held that tariff regime was 'not merely an economic and monetary policy of the Argentine government' but a set of rights granted and specifically guaranteed by the state. LG&E relied on these 'key guarantees' in making its decision to invest. By abandoning the tariff regime Argentina breached LG&E's legitimate expectations and, therefore, the FET standard.[716]

The key clause in the *LG&E* Tribunal's statement is the requirement that expectations 'must exist and be enforceable by law'. The requirement that expectations must *exist by law* imposes a condition that an expectation be grounded in the legal entitlements of the investor

[713] ibid [102]-[105].

[714] Text to n 700.

[715] *LG&E Energy* (n 679) [130].

[716] ibid [133]-[134].

under the domestic law of the state (or in the proper law of a contract or licence on which the expectation is based). An expectation that is based on a unilateral statement made by the host state would not meet this condition, except in the narrow circumstance in which domestic law itself recognises the unilateral statement as creating a right vested in the investor. The requirement that expectations must be *enforceable by law* further circumscribes the set of legal entitlements that are capable of supporting a legitimate expectation. At any given time, a state will have a number of laws and regulations in force. However, it would be rare for an investor to have an *enforceable* right for its entitlements under general regulations to remain unchanged unless the state has specifically agreed to maintain or guarantee the continuation of existing arrangements through a contract or licence agreement with the investor.

Under the criteria laid down by the *LG&E* Tribunal, the requirement that an expectation rest on a specific legal right vested in the investor is necessary, but not sufficient, for the expectation to be protected by the FET standard. The Tribunal also held that an expectation must be fair, an assessment that required consideration of 'parameters such as business risk or industry's regular patterns.'[717] Moreover, the Tribunal held that to recover for breach of a legitimate expectation an investor must have relied on the expectation in making its initial investment.[718]

5.5.1.2 Other decisions consistent with LG&E

The *LG&E* Tribunal's interpretation of the doctrine of legitimate expectations was cited and applied in *BG v Argentina*, a case brought by another gas investor based on the same facts. The *BG* Tribunal emphasised that the tariff regime itself and provisions relating to the stability of the tariff regime were incorporated in the gas licences and stressed that Argentine

[717] ibid [130].

[718] ibid.

law recognised these interests as 'legitimately acquired rights' vested in the investor.[719] The reversal of these commitments breached the claimant's legitimate expectations.

In another case brought against Argentina, the consolidated *Suez* claims, the claimants alleged that a number of measures affecting their investment in a Buenos Aires water concession breached the FET standard. Foremost among these was Argentina's refusal to revise water tariffs according to the legal framework established by the concession contract.[720] It noted that the claimants' expectations were basic terms of the concession contract. These expectations 'were not established unilaterally but by the agreement between Argentina and the Claimants; and they existed and were enforceable by law.'[721] Accordingly, Argentina was liable under the FET standard.

Other decisions have limited the doctrine of legitimate expectations to the protection of vested legal rights without citing the *LG&E* award. The case of *MCI v Ecuador* arose from a dispute under an electricity contract between the investor and INECEL, a governmental entity. The Tribunal rejected the notion that the doctrine of legitimate expectations protected 'the basic assumptions on which the investor made the investment.'[722] It held that:

> The legitimacy of the expectations for proper treatment entertained by a foreign investor protected by the BIT does not depend solely on the intent of the parties, but on certainty about the contents of the enforceable obligations.[723]

[719] '[D]erecho legítimamente adquirido', *BG Group* (n 613) [308].

[720] *Suez and Vivendi* (n 137) [79]-[80].

[721] ibid [231].

[722] *MCI Power* (n 606) [237].

[723] ibid [278].

As the claimant could not prove the violation of an 'enforceable obligation' owed by INECEL or an 'acquired right' vested in the claimant, it could not succeed in its claim for breach of legitimate expectations.[724]

Similar issues were raised in *EDF v Romania*. The claim arose from a set of contractual disputes between the investor and state entities relating to its investment in airport duty free shops. The central claims of the investor were that the state had failed to extend its contract to provide duty free sales beyond its initial term; and that the state subsequent abolished duty free sales in airports. The claimant argued that it had a legitimate and reasonable expectation of the continued operation of its business.[725] The Tribunal disagreed:

> The idea that legitimate expectations, and therefore FET, imply the stability of the legal and business framework, may not be correct if stated in an overly-broad and unqualified formulation.[726]

It went on to state that the claim for breach of legitimate expectations 'presupposes that the acts or the conduct in question were in breach of AIBO's and TAROM's [the state entities] contractual obligations.'[727]

The decision is particularly significant for its attempt to clarify the relationship between unilateral governmental statements and the doctrine of legitimate expectations. The Tribunal held that:

> To validly claim a breach of the FET standard under the BIT, Claimant should have proven not only a breach of the SKY Contract, but also that such other assurances had been given by the Government and had been breached.[728]

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[724] ibid [322]-[325].

[725] *EDF* (n 470) [243].

[726] ibid [217].

[727] ibid [240].

[728] ibid [298]

In the Tribunal's view, the relevance of governmental representations was that they weigh in the determination of which expectations based on legal rights rise to the status of *legitimate* expectations that are protected by the FET standard.

In the case of *Metalpar v Argentina*, the investor alleged that the changes made during the Argentine financial crisis to Argentina's regime of currency convertibility breached its legitimate expectations relating to its investment in a bus manufacturing company.[729] The Tribunal gave the claim short shrift. It reviewed a range of decided cases and found that, in every case where a legitimate expectations claim had been successful 'the government [had] refused to renew or comply with [a] contract, license or permit.'[730] The fact that the claimant had 'no bid, license, permit or contract of any kind' with the state was sufficient to show that it could have no legitimate expectation that the currency regime would not change.[731]

A further set of decisions is consistent with the proposition that the doctrine of legitimate expectations is limited to the protection of vested legal rights, without expressly foreclosing the possibility that expectations could be based on other forms of state conduct in other cases. In the recent decision *Paushok v Mongolia*, the claimant, an investor engaged in the mining of gold, argued that the introduction of windfall profits tax on the sale of gold breached its legitimate expectations. The tax was calculated at the rate of 68% on the portion of the sale price exceeding a base price of USD 500 an ounce.[732] While noting that the tax imposed a significant burden on the operation of the investment, the Tribunal held that governments regularly change their tax policies and that, in the absence of a stabilisation agreement with the host state, an investor could not legitimately expect tax arrangements to

[729] *Metalpar v Argentina* ICSID Case No ARB/03/5, Award on the Merits, 6 June 2008 [116].

[730] ibid [185].

[731] ibid [186]-[187].

[732] *Sergei Paushok v Mongolia*, Award on Jurisdiction and Liability, 28 April 2011 [104].

remain unchanged.[733] In *Eureko* the Tribunal held that the Polish state 'consciously and overtly' refused to respect the terms of its contract with the investor, thereby breaching 'the basic expectations' of the investor.[734] The NAFTA claim in *GAMI v Mexico* failed because the investor's expectation that the state would enforce sugar quotas was not based on any obligation on the state under Mexican law.[735]

5.5.1.3 Restatement of the legal rights approach

Taken together, these cases constitute a coherent interpretation of the doctrine of legitimate expectations under the FET standard. This interpretation of the doctrine can be restated as follows:

1. An expectation can only qualify for protection under the FET standard if it is based on a specific legal right vested in the investor.
2. Not all expectations based on specific legal rights qualify for protection under the doctrine. An expectation must also be legitimate and reasonable in the circumstances. This determination must be made in light of normal business risk, the regulatory patterns in the industry and any specific representations made by the state to the investor. The expectation must also be basic to the investment.
3. To recover for the infringement of a legitimate expectation, the investor must have relied on the expectation in making the decision to invest.

The domestic law of the host state plays an important role in this interpretation of the doctrine of legitimate expectations. However, this understanding of legitimate expectations does not reduce to a question of the legality of state conduct under domestic law. For

[733] ibid [302].

[734] *Eureko* (n 656) [232]; similarly, *Alpha Projektholding v Ukraine* ICSID Case No ARB/07/16, Award, 8 November 2010 [421]-[422].

[735] *GAMI* (n 623) [76].

example, what was crucial for the *LG&E* and *BG* Tribunals was that the gas licences granted gas companies specific and enforceable legal rights under Argentine law. It may well have been that, under Argentine constitutional law, it was legal for the state to subsequently repudiate these rights in an emergency situation. This issue was not decisive. Having created specific and enforceable legal rights under domestic law, the doctrine of legitimate expectations was activated; the subsequent treatment of these rights was then assessed according to an international standard.

5.5.2 Legitimate expectations based on state conduct

A broader view of the scope of the doctrine of legitimate expectations is that it protects investors from modification of the regulatory arrangements governing an investment and actions contrary to prior unilateral statements made by the state. Further criteria then determine the circumstances in which an interference with expectations resting on either of these bases will amount to a breach of legitimate expectations. The principle that justifies these two, potentially distinct, bases for expectations seems to be that both are official 'positions' taken by a host government. These positions may – but need not – entail the vesting of specific legal rights in the investor. The doctrine of legitimate expectations then functions as a liability rule requiring a state to compensate an investor when it changes a position on which the investor has relied.[736] In keeping with this rationalisation of the doctrine, tribunals have described the protection of investors' expectations as embodying principles of 'stability', 'consistency' and 'predictability'.[737] The overwhelming majority of

[736] Grierson-Weiler and Laird (n 635) 275, arguing that the doctrine is based on the 'concept of detrimental reliance'; Newcombe and Paradell (n 152) 279, arguing that the doctrine is 'closely related to the principle of estoppel and state responsibility under public international law for unilateral acts.'; W. Michael Reisman and Mahnoush Arsanjani, 'The Question of Unilateral governmental Statements as Applicable Law in Investment Disputes' (2004) 19 ICSID Review - FILJ 328, 342; similarly, *Thunderbird* (n 637) [147].

[737] *Occidental* (n 204) [191]; *CMS* (n 584) [276]; *Tecmed* (n 484) [154].

academic commentary accepts and endorses this interpretation of the scope of the doctrine of legitimate expectations.[738]

This section deals with decisions united by a shared view of the scope of the doctrine of legitimate expectations: that the doctrine protects expectations based on either unilateral statements or general regulations. Among tribunals that agree with this general formulation of the scope of the doctrine, there is a range of views about the criteria by which *legitimate* expectations should be distinguished from those that do not qualify for protection under the FET standard. In this section I argue that the decisions coalesce around two approaches – a strict approach that requires specific conduct directed towards the investor and a permissive approach that places substantially less emphasis on the specificity of the statements or regulations to the investor. Each approach can be characterised as a coherent interpretation of the doctrine of legitimate expectations.

5.5.2.1 Unilateral statements: the strict approach

The majority in the NAFTA Tribunal *Thunderbird* articulated the view that expectations protected by the FET standard could be derived from the host state's conduct without any requirement that such conduct create legal rights vesting in the investor:

> [T]he concept of 'legitimate expectations' relates, within the context of the NAFTA framework, to a situation where a Contracting Party's conduct creates reasonable and justifiable expectations on the part of an investor (or investment) to act in reliance on said conduct, such that a failure by the NAFTA Party to honour those expectations could cause the investor (or investment) to suffer damages.[739]

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[738] Dolzer, 'Fair and Equitable Treatment' (n 577) 103; Schreuer, 'Fair and Equitable Treatment' (n 701) 386; Snodgrass (n 632) 34; Stephen Fietta, 'Expropriation and the "Fair and Equitable Treatment" Standard' in Federico Ortino and others (eds), *Investment Treaty Law: Current Issues II* (British Institute of International and Comparative Law 2007) 189; Thomas Westcott, 'Recent Practice on the Fair and Equitable Treatment' (2007) 8 The Journal of World Investment and Trade 409, 425; Kinnear (n 594) 227; Salacuse (n 32) 232.

[739] *Thunderbird* (n 637) [147], [196].

In the same paragraph the majority also indicated that, in order to be *legitimate*, an expectation based on a state's conduct must be 'reasonable and justifiable'. In applying this standard to the facts, the Tribunal gave more precise content to these limitations.

Thunderbird was a gaming company, seeking to install its gaming machines in Mexico. Mexican law banned gambling machines. Thunderbird requested an official opinion concerning the legality of its gaming machines under Mexican law from SEGOB, the relevant regulatory authority.[740] In its request Thunderbird declared that its machines operated according to the users 'skills and abilities', not 'chance and wagering or betting'.[741] In its official response, SEGOB explained that Mexican law banned machines in which 'the principal factor ... is luck or gambling'; and stated that, if the investor's machines operated in the manner in which the investor had described, they would be permissible under Mexican law.[742] One year later, on its own motion, the Mexican authorities held an administrative hearing to determine whether Thunderbird's machines complied with Mexican law. Thunderbird appeared and gave evidence. SEGOB, subsequently determined that Thunderbird's machines did not comply with Mexican law.[743]

The majority held that Thunderbird's legitimate expectations had not been breached. It noted that the information provided in Thunderbird's request for an official opinion was both incomplete and inaccurate.[744] SEGOB's response was explicitly conditional on the accuracy of this information. As such, it was not a clear and specific statement on which

[740] ibid [48].

[741] ibid [50].

[742] ibid [55].

[743] ibid [70]-[73].

[744] ibid [151].

Thunderbird could reasonably have relied.[745] In addition, the Tribunal noted that Thunderbird had already begun to install its machines in Mexico prior to SEGOB's official response. On this basis, it doubted whether Thunderbird's investment had been made in reliance on SEGOB's response.[746]

In the recent decision in *Total v Argentina* – another case arising out of events in the Argentine gas sector – the Tribunal agreed that unilateral representations were capable of creating legitimate expectations. However, it was careful to limit the scope of the doctrine to situations where the representations were clear and specific to the investor:

> Representations made by the host State are enforceable and justify the investor's reliance only when they are specifically addressed to a particular investor.[747]

It argued that the assessment of whether a given expectation was legitimate required consideration of the state's 'right to regulate' and an assessment of whether the state's actions were reasonable and proportionate.[748] On the facts, the tribunal distinguished the findings of the other Argentine gases. It held that Total had invested a decade after other investors and, as such, was not an addressee of the promises made at the time of privatisation.[749]

In *Duke Energy v Ecuador* the Tribunal accepted that expectations could be derived from 'conditions that the State offered the investor' at the time of the investment, without any

[745] ibid [159]-[161].

[746] ibid [167].

[747] *Total v Argentina* ICSID Case No ARB/04/1, Decision on Liability, 27 December 2010 [119].

[748] ibid [123].

[749] ibid [144].

requirement that the offer be embodied in a legally effective form.[750] The Tribunal also noted that the assessment of whether an expectation is legitimate:

> [M]ust take into account all circumstances, including not only the facts surrounding the investment, but also the political, socioeconomic, cultural and historical conditions prevailing in the host State.[751]

The Tribunal held that a state's contractual agreement to guarantee payments owed to the investor by the electricity regulator created a legitimate expectation.[752] The Tribunal dismissed a further claim arising from an arbitration agreement on the grounds that the doctrine of legitimate expectations did not protect expectations created by the state after an investor has made its investment.[753]

The Tribunal in *Bayindir v Pakistan* affirmed the comments made in *Duke Energy*.[754] It held that the claimant could not derive legitimate expectations from the fact that the former Prime Minister had been a key supporter of its highway construction project.[755] Specifically, the claimant could not expect that, following a change of government, the state would refrain from exercising its right to terminate a construction contract as a result of the claimant's defective performance.[756]

The *Biwater v Tanzania* Tribunal also stressed the importance of weighing 'countervailing factors' in the assessment of whether an expectation is legitimate. These included:

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[750] *Duke Energy* (n 613) [340]; similarly, *GEA Group V Ukraine* ICSID Case No ARB/08/16, Award, 31 March 2011 [287], [291].

[751] *Duke Energy* (n 613) [340].

[752] ibid [362]-[364].

[753] ibid [365].

[754] *Bayindir* (n 576) [190]-[191].

[755] ibid [194].

[756] ibid [197]; similarly, *Saluka* (n 165).

> [T]he responsibility of foreign investors, both in terms of prior due diligence as well as subsequent conduct; the limit to legitimate expectations in circumstances where an investor itself takes on risks in entering a particular investment environment; and the relevance of the parties' respective rights and obligations as set out in any relevant investment agreement ...[757]

In *National Grid v Argentina* the investor was a shareholder in a privatised electricity transmission and distribution company. The case raised essentially the same issue as the *LG&E*, *BG* and the other Argentine gas cases – whether the abandonment of a dollar-denominated tariff regime during the Argentine crisis, which had applied to a public utility and to which the utility was contractually entitled, breached the claimant's legitimate expectations.[758] The Tribunal began by observing that FET standard 'protects the reasonable expectations of the investor at the time it made the investment and which were based on representations, commitments or specific conditions offered by the State concerned.'[759] The Tribunal recognised much the same limitations on the doctrine as *Duke Energy*, including the fact that Argentina's financial crisis must carry some weight in the assessment of legitimate expectations.[760] However, it went on to find that the claimant had a legitimate expectation that the tariff regime would continue in force, because the tariff regime had been specifically advertised to the claimant in the prospectus that the Argentine government used to attract foreign investors to the electricity transmission industry.[761] As such, the Tribunal found that the liability of the state stemmed from its departure from a prior unilateral statement (the prospectus), not from the fact that it had repudiated rights created by the concession contract.

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[757] *Biwater* (n 485) [601].

[758] *National Grid* (n 608) [117]-[125].

[759] ibid [173].

[760] ibid [175].

[761] ibid [176]-[179].

5.5.2.2 General regulatory arrangements: the strict approach

Thunderbird, *Duke Energy*, *Bayindir*, *National Grid* and *Biwater* all dealt with factual scenarios in which the purported expectations were based on investor-state contracts or representations made by the host state. They did not attempt to articulate the circumstances in which an investor could rely on an expectation that existing legal arrangements would remain in force. This question has been explored by other tribunals.

In 2000, the NAFTA decision *SD Myers* suggested that regulatory change would not normally breach the FET standard. It argued that any determination of liability under the FET standard:

> [M]ust be made in the light of the high measure of deference that international law generally extends to the rights of domestic authorities to regulate matters within their own borders.[762]

While the *SD Myers* decision did not discuss the protection of an investor's legitimate expectations, this passage was cited by the Tribunal in *Saluka* to justify its view that legitimate expectations based on general regulatory arrangements must be balanced against state's regulatory prerogatives.[763] The *Saluka* Tribunal concluded that:

> No investor may reasonably expect that the circumstance prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well.[764]

This first sentence of this dictum suggests that a tribunal should consider host states' regulatory prerogatives in determining whether a given expectation is legitimate. The second sentence of this dictum suggests that a tribunal should, first, determine whether an investor has a legitimate expectation and, then, in a separate stage of analysis, determines whether the

[762] *Saluka* (n 165) [305], citing *SD Myers* (n 487) [263].

[763] *Saluka* (n 165) [305].

[764] ibid.

frustration of that expectation was justified. The latter structure of inquiry has not found favour with other tribunals, regardless of the way in which they have interpreted the standard. Instead, tribunals have uniformly adopted the former structure of inquiry, integrating any analysis of the justifications for a state's conduct into the determination of whether a given expectation was legitimate in the circumstances.[765]

CMS v Argentina raised the same set of facts involving the Argentine gas industry as *LG&E* and *BG*.[766] Although the *CMS* Tribunal observed elsewhere in the decision that the tariff regime was embodied in the terms of licence held by the investor, it did not refer to these facts in its application of the FET standard.[767] Rather, the Tribunal found the liability of the state arose from changes to the general regulatory framework governing the investment. This basic obligation on the state was to provide 'a stable legal and business environment'.[768] The changes to the tariff regime 'did in fact entirely transform and alter the legal and business environment under which the investment was decided and made.'[769] The Tribunal found that the claimant's expectations of stability in the regulatory regime were buttressed by 'specific commitments' that the regime would not be changed.[770]

The Tribunal in *Continental Casualty* made a more structured attempt to reconcile the protection of expectations based on general regulatory arrangements with the principles governing the protection of expectations based on unilateral statements and specific legal

[765] *Thunderbird* (n 637) [147]; *Duke Energy* (n 613) [340]; *Continental Casualty v Argentina* ICSID Case No ARB/03/9, Award, 5 September 2008 [261]; *Thunderbird, Separate Opinion* (n 632) [64]; *Enron* (n 584) [264]; *Sempra* (n 608) [303].

[766] Text to n 713.

[767] *CMS* (n 584) [133].

[768] ibid [274].

[769] ibid [275].

[770] ibid.

rights vested in the claimant. It held that, in the assessment of whether a breach of legitimate expectations has occurred, a tribunal should consider:

> i) [T]he specificity of the undertaking allegedly relied upon which is mostly absent here, considering moreover that political statements have the least legal value, regrettably but notoriously so;
>
> ii) general legislative statements engender reduced expectations, especially with competent major international investors in a context where the political risk is high. Their enactment is by nature subject to subsequent modification, and possibly to withdrawal and cancellation ... ;
>
> iii) unilateral modification of contractual undertakings by governments, notably when issued in conformity with a legislative framework and aimed at obtaining financial resources from investors deserve clearly more scrutiny, in the light of the context, reasons, effects, since they generate as a rule legal rights and therefore expectations of compliance;[771]

In these three paragraphs the Tribunal suggests a hierarchy in the sources of expectations in which specific legal rights deserve the most protection, followed by specific undertakings made to the investor. In the Tribunal's hierarchy, general statements and expectations based on the existing legislative framework deserve the least protection. The question of whether any expectation was legitimate would then involve a balancing exercise in which the centrality of the expectation to the investment was weighed against the public interest of the state.[772] Continental Casualty had asserted an expectation of the continued operation of Argentina's regime of currency convertibility based only on the general legislative position of the state. Applying its understanding of the doctrine, the Tribunal held that the prior legislative framework did not provide the basis for a legitimate expectation.[773]

Other decisions accord with the view that it is difficult to establish that a general regulatory position taken by the state forms the basis of an expectation protected by the FET

[771] *Continental Casualty* (n 765) [261].

[772] ibid.

[773] ibid [259]-[260].

standard. Indeed many suggest that a general regulatory position cannot form the basis of an expectation in the absence of a supportive statement or assurance made by the host state. In *PSEG v Turkey*, the Tribunal addressed a claim based on changes of the legal regime governing the award of build, operate and transfer power contracts under Turkish law.[774] In rejecting this element of the claim, it held that '[l]egitimate expectations by definition require a promise of the administration on which the Claimants rely to assert a right that needs to be observed.'[775]

The view of the Tribunal in the NAFTA case of *Glamis Gold* is perhaps even more restrictive. It held that no 'quasi-contractual inducement' had been offered by the state to the investor.[776] In the absence of such an inducement, a change in the environmental remediation regulations that would apply to the gold mine that the claimant was seeking to construct could not have breached its legitimate expectations. It was irrelevant that the 'imposition of mandatory backfilling requirements surprised the claimant and upset its [subjective] expectations.'[777]

5.5.2.3 Restatement of the strict conduct approach

There are certain differences in emphasis among these decisions. However, they coalesce around a set of propositions about the doctrine of legitimate expectations that can be restated with a degree of precision. With respect to the scope of the doctrine:

1. An expectation need not be based on a legal right vested in the investor. A unilateral statement made by the host state may be the basis for an expectation. In order for a

[774] *PSEG* (n 608) [13]-[44].

[775] ibid [241]; similarly, *Plama* (n 165) [219]; *AES Summit Generation v Hungary* ICSID Case No ARB/07/22, Award, 23 September 2010 [9.3.18].

[776] *Glamis Gold* (n 514) [767].

[777] ibid [810].

statement to be the basis for an expectation it must be made by governmental officials in their official capacity, and be clear and have a degree of specificity to the claimant. An expectation may also be based on general regulations in force at the time the investment was made, if the state has indicated that the regulations would not be changed.

With respect to the criteria by which *legitimate* expectations are identified:

2. The assessment of whether a given expectation is a balancing exercise involving consideration of all the circumstances relating to the investment. This includes consideration of whether the expectation goes beyond what the investor is legally entitled to under domestic law, as well as whether the expectation is reasonable given the 'political, socioeconomic, cultural and historical conditions' in the host state. Expectations based on the general regulatory framework should be assessed more strictly, in light of the right of states to modify their regulatory arrangements in the public interest.

With respect to the reliance:

3. To recover for the infringement of a legitimate expectation, the investor must have relied on the expectation in making the decision to invest.

5.5.2.4 Unilateral statements: the permissive approach

The roots of a more permissive approach to legitimate expectations based on unilateral statements can be found in *Tecmed*. The case concerned a hazardous waste facility. The investor held a licence to operate the facility for one year, which was renewable annually. In response to community opposition to the facility, the authorities and the investor agreed that the facility should be moved to a different location. This agreement was not documented in

written form. Within months of this agreement, the authorities declined to renew the annual licence that allowed the facility to operate at its original site.[778] The investor argued that it had a legitimate expectation that the facility would be permitted to continue to operate until it could be relocated.

The Tribunal's reasoning is difficult to follow. There is no doubt that it took a dim view of the authorities' conduct, which seems to have been coloured by earlier changes to the licensing regime that had occurred prior to the entry into force of the BIT.[779] What is clear is that the Tribunal found that the decision not to renew the licence breached the investor's legitimate expectation that the old facility would be permitted to continue to operate until it could be relocated.[780] What distinguishes the decision from those taking a stricter approach to expectations based on unilateral statements, is that the Tribunal did not identify a specific assurance that the investor's licence would be renewed. The closest the Mexican authorities had come to such a statement was in issuing a declaration that the original facility 'shall be closed as soon as the new facilities are ready to operate.'[781] The Tribunal did not find that this declaration constituted an implicit promise *relating to the licence*. Rather, liability under the FET standard stemmed from the fact that, in a context in which there had been active negotiations between the investor and the authorities, the authorities had not given 'an explicit, transparent and clear warning' that the facility would be closed prior to relocation.[782]

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[778] *Tecmed* (n 484) [160].

[779] ibid [68], [171]-[172]. Whether the Tribunal was justified in taking these events into account – more specifically, whether the Tribunal misapplied VCLT (n 139) art 28 – raises jurisdictional issues beyond the scope of this thesis.

[780] ibid [173].

[781] ibid [160].

[782] ibid [160], [163].

Furthermore, expectations derived from the statements and negotiations concerning relocation could only have arisen *after* the investor had made its original investment in the facility. The *Tecmed* Tribunal did not make a finding that relocation exercise, itself, constituted an investment. As such, it appears that the investor did not make an investment in reliance on the expectation identified by the Tribunal. This fact did not preclude the investor from succeeding in its claim.

Professor Wälde's dissent in *Thunderbird* provides a way to rationalise the *Tecmed* decision, so far as it concerns legitimate expectations. The facts of *Thunderbird* are described in the previous section.[783] Professor Wälde agreed with the majority that Thunderbird's request for an opinion was 'factually – with the hindsight of this tribunal's expertise – incorrect' and that the regulator's response was phrased as conditional on the accuracy of the investor's information.[784] Professor Wälde also stressed that legitimate expectations could only be created by officials acting in their official capacity and that SEGOB had been acting in its official capacity.[785] (This was not a point of contrast with the majority; it is a condition of the creation of a legitimate expectation accepted, either explicitly or implicitly, by all arbitral decisions that allow expectations to be based on unilateral statements of the host state.)

The key difference between Professor Wälde and the majority concerned a question of law, not a finding of fact. The difference was the degree of specificity required of a unilateral statement for it to justify a legitimate expectation. The majority had held that, as SEGOB's response did not contain any clear or specific assurance that Thunderbird's machines were permitted under Mexican law, Thunderbird could not expect that its machines were

[783] Text to n 743.

[784] *Thunderbird, Separate Opinion* (n 632) [63]-[64].

[785] ibid [31].

permitted. In contrast, Wälde held 'that the risk of ambiguity falls square on the shoulders of the assurance-issuing public authority'.[786] The fact that SEGOB's response could reasonably have been understood by the investor as suggesting approval of the machines was, on his interpretation of the doctrine, sufficient to establish a legitimate expectation.[787]

5.5.2.5 General regulatory arrangements: the permissive approach

Other decisions are united by a more permissive approach to the extent to which an investor can legitimately expect a state to maintain the general regulatory framework in place at the time of the investment. These decisions are all sparsely reasoned. As such, it is difficult to uncover the exact contours of a distinct interpretation of the doctrine of legitimate expectations. Nevertheless, the essential features of a permissive approach can be brought into clearer focus through comparison with the stricter approach of decisions like *Saluka*, *Continental Casualty*, *Plama* and *Glamis Gold*.[788] In contrast to the stricter approach, decisions adopting a more permissive approach emphasise that the FET standard grants investors a freestanding entitlement to the stability of the legal arrangements under which the investment was made.

A key decision developing this approach is *Occidental v Ecuador*. The dispute concerned the reimbursement of value-added tax (VAT) paid by the investor under a petroleum contract between the investor and the state. For the first two years of the contract, the Ecuadorian tax authorities refunded VAT on application from Occidental. The tax authorities then issued a resolution denying further refunds and demanding the repayment of refunds previously paid. The authorities justified this change in policy on the basis that the contract itself, through a participation formula that entitled the claimant for reimbursement of

[786] ibid [57], [77].

[787] ibid [64].

[788] Text n 764 to n 777.

its expenses, already provided the investor with the refunds to which it was entitled.[789] The investor argued that the change in policy of the tax authorities breached the legitimate expectations on which the investment was based.[790]

The two issues of domestic law put to the Tribunal were: whether Occidental was entitled to a refund of VAT under Ecuadorian tax law and; if so, whether this reimbursement was accounted for by the participation formula. The Tribunal found in Occidental's favour on both issues.[791] These findings would have been sufficient for the Tribunal to hold that the FET standard had been breached by the tax authority's refusal to honour Occidental's acquired right under Ecuadorian law to a refund on tax already paid. However, the Tribunal shied away from structuring its reasoning in this way. Instead, it held that 'the stability of the legal and business framework is ... an essential element of fair and equitable treatment.'[792] While noting that the tax authorities had justified their change of policy by asserting a 'manifestly wrong' interpretation of the contract, the primary basis for liability in the Tribunal's decision was that 'the framework under which the investment has been made and operates has been changed in an important manner.'[793]

Both *Sempra v Argentina* and *Enron v Argentina* were based on the events in the Argentine gas industry considered in *LG&E*, *BG* and *CMS*.[794] The same arbitrator presided over both Tribunals, and the reasoning of the two Tribunals follows a similar pattern. In addressing the claimant's FET claim, the *Enron* Tribunal held that the doctrine of legitimate

[789] *Occidental* (n 204) [27]-[32].

[790] ibid [181].

[791] ibid [143].

[792] ibid [183].

[793] ibid [184].

[794] Text to n 713.

expectations protects 'expectations derived from the conditions that were offered by the State to the investor at the time of the investment'.[795] It understood 'conditions offered' as a category that includes the regulatory framework at the time an investment is made, in addition to those derived from unilateral statements made by the host state.[796] The Tribunal found that Argentina breached the FET standard when it 'substantially changed the legal and business framework under which the investment was decided and implemented.'[797]

While the *Enron* Tribunal also referred to 'the guarantees of the tariff regime' – a comment that could be read as an allusion to the fact that the tariff regime was incorporated into the terms of the licence acquired by the investor – its conclusion that Argentina had breached the FET standard did not turn on an analysis of the legal rights vested in the investor.[798] For the Tribunal, the crucial finding was that the '"stable legal framework" that induced the investment is no longer in place and that a definitive framework has not been made available for almost five years.'[799]

5.5.2.6 Restatement of the permissive conduct approach

Again, there are differences in emphasis among these decisions. However, they are distinguished by a more permissive approach to the conduct that is capable of creating legitimate expectations. With respect to the scope of the doctrine:

1. Legitimate expectations may be based on unilateral statements made by the host state. Expectations need not be based on a clear statement of the state's position; in the

[795] *Enron* (n 584) [262].

[796] ibid [265]; similarly, *Sempra* (n 608) [298].

[797] *Enron* (n 584) [264]; similarly, *Sempra* (n 608) [303].

[798] *Enron* (n 584) [154], [266].

[799] ibid [267].

context of a specific relationship between a governmental authority and an investor, the risk of ambiguity in unilateral statements made by the authority must be borne by the state. An expectation may also be based on general regulations in force at the time the investment was made.

With respect to the criteria by which *legitimate* expectations are identified:

2. The assessment of whether a given expectation is legitimate still involves a balancing exercise, but the perspective of the investor weighs more heavily in this balance than it would under the stricter approach. Expectations based on unilateral statements are legitimate if they are derived from a reasonable interpretation of an ambiguous statement. The key issue in determining whether an expectation based on a general regulation is legitimate seems to be whether altered regulation was a basic element of the legal regime governing the investment at the time it was made.

With respect to the reliance:

3. To recover for the infringement of a legitimate expectation based on a general regulation, the investor must have relied on the expectation in making the decision to invest. However, there is some suggestion that an investor may recover from the breach of expectations created by unilateral statements that it did not rely on in making an investment.

5.5.2.7 Postscript: are contractual rights excluded from the doctrine of legitimate expectations?

The Tribunal in *Parkerings v Lithuania* observed that an expectation:

> [I]s legitimate if the investor received an explicit promise or guaranty from the host-State, or if implicitly, the host-State made assurances or representation that the investor took into account in making the investment.[800]

This much is consistent with both the strict conduct and the permissive conduct interpretations of the FET standard. However, the *Parkerings* Tribunal went on to contend that 'contracts involve intrinsic expectations from each party that do not amount to expectations as understood in international law.'[801] This comment suggests an investor's contract with the host state cannot form the basis of an expectation protected by the FET standard. While arbitral decisions are unanimous in agreeing that not all breaches of contract are breaches of legitimate expectations,[802] there are serious doctrinal difficulties with the position that a breach of contract is never a breach of legitimate expectations. The latter proposition entails the result that, when an investor enters into a legally binding agreement with a host state about the arrangements to govern a particular investment, it reduces the degree of protection which the FET standard provides from change to these arrangements. This result is not doctrinally coherent.

The situation in *Parkerings* was complicated by an exclusive forum selection clause in the investor's contract with the state.[803] However, even this cannot justify the view that conduct that breaches a contract is excluded from review under the FET standard.[804] A claim for breach of the FET standard is a claim for breach of a treaty standard, not a claim for

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[800] *Parkerings* (n 579) [331].

[801] ibid [344].

[802] *Hamester v Ghana* ICSID Case No ARB/07/24, Award, 18 June 2010 [335].

[803] *Parkerings* (n 579) [436].

[804] Ole Spiermann, 'Premature Treaty Claims' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 484; Ursula Kriebaum, 'Local Remedies and the Standards for the Protection of Foregin Investment' in Christina Binder and others (eds), *International Investment Law for the 21st Century* (Oxford University Press 2009) 447.

breach of a contract.[805] It may be relevant for a tribunal to come to a view about whether a contract has been breached, but only to the extent it goes to the question of whether the treaty standard has been breached. The jurisdictional basis for an FET claim is the parties' consent to arbitration of disputes under the treaty, not the jurisdiction to resolve contractual disputes; it is the latter that is constrained by a contractual choice of forum clause.[806] In any case, the *Parkerings* Tribunal's comments were not confined to rights created by contracts with forum selection clauses.

No other decision has followed the *Parkerings* Tribunal on this point. Because of the doctrinal problems with the Tribunal's position, it should not be accepted as coherent interpretation of the doctrine of legitimate expectations.

5.5.3 Legitimate expectations based on the business plans of the investor

A handful of decisions take a broader view of the doctrine of legitimate expectations. What distinguishes these cases from those reviewed in previous sections is that, in each of them the investor succeeded in a claim for breach of legitimate expectations when the protected expectation was neither based on a legal right vested in the investor, nor on a unilateral statement of the host state, nor on the regulations in force at the time the investment was made. These decisions are best rationalised as protecting expectations based on the business plans of the investor, when the state knew, or should have known, that the impugned conduct would upset the investor's business plans. Most commentators agree that, as a matter of legal doctrine, an investor's subjective expectations are not protected by the FET standard.[807] This

[805] Crawford, 'Treaty and Contract in Investment Arbitration' (n 708) 358; *Compañia de Aguas del Aconquija SA and Vivendi Universal SA v Argentine Republic* ICSID Case No ARB/97/3, Decision on Annulment, 3 July 2002 [101], [105].

[806] The situation is more complex when a claim is brought before an international tribunal under an 'umbrella clause' of an IIT. The jurisdictional and substantive issues relating to umbrella clauses are well beyond the scope of this thesis.

[807] Kinnear (n 594) 230; similarly, *Saluka* (n 165) [304].

thesis does not take a position on the issue. It is, however, important to note that the three decisions reviewed in this section come close to allowing an investor to recover for interference with its subjective expectations.

5.5.3.1 MTD, Bogdanov *and* Bau

The case of *MTD v Chile* concerned an investor's proposal to redevelop land near Santiago. The investor acquired land that was not zoned for redevelopment. It then applied for permission to import capital into Chile to fund the project, a transfer which required the approval of the Chilean Foreign Investment Commission (FIC).[808] The application to transfer funds into Chile required the investor to specify the location and nature of the investment project to which the funds related. The FIC, a national agency, approved the transfer of funds into Chile. The relevant local authority subsequently refused MTD's request to rezone the land for redevelopment. MTD claimed that the FIC's decision created an expectation that the proposed redevelopment could proceed in the specified location.[809]

The Tribunal accepted Chile's argument that, as a question of Chilean law, approval of the import of capital did not entitle the investor to proceed with the project without complying with local planning regulations.[810] Indeed, the FIC's approval explicitly noted that all investment projects were required to comply with other applicable national laws.[811] Moreover, the Tribunal did not identify any unilateral statement made by the host state which suggested that the land would be rezoned; or that the national authorities would override normal local zoning procedures; or that the investment would be exempted from zoning requirements. Nevertheless, the Tribunal characterised the approval of capital transfer and

[808] *MTD* (n 576) [162].

[809] ibid [116].

[810] ibid [163].

[811] ibid [188].

rejection of rezoning as an 'inconsistency of action between two arms of the same Government vis-a-vis the same investor'.[812] In its view, the authorisation to import capital gave 'prima facie to an investor the expectation the project is feasible in that location from a regulatory point of view.'[813] The local authority's refusal to rezone the land breached this expectation.[814]

The Tribunal's assertion that liability rested on the inconsistency of Chile's conduct is doctrinally problematic. In many legal systems an investor must comply with a range of different regulations simultaneously. The fact a factory owner must comply with both environmental regulations and tax law is not normally regarded as constituting an inconsistency. Rather, the *MTD* decision seems to rest on the findings of fact that: the Chilean state was put on notice of MTD's business plans; it acted in a way that allowed MTD to pursue these plans; and then subsequently acted in a way that upset these plans. According to the Tribunal's interpretation of the doctrine of legitimate expectations, these three facts were *sufficient* to establish Chile's liability.

The case of *Bogdanov v Moldova* also arose from a relatively simple set of facts. The claimant had signed a privatisation contract with the state. The contract provided that the claimant would transfer assets to the state in exchange for shares in other, unspecified, state-owned companies. After the contract had been signed, the Moldovan authorities drew up a list of Eligible Compensation Shares in state-owned companies with which the claimant could be compensated. The claimant argued that that all the available shares deprived the compensation mechanism of its substance, as the market value of the shares was below their

[812] ibid [163].

[813] ibid.

[814] ibid [189].

face value.[815] The Tribunal found that, under the proper law of the contract at the time it was signed (and at all subsequent times), there was no limit on the state's discretion to nominate which shares in state-owned companies would be offered as compensation shares. It also found that the contract entitled the state to offer shares at their face value, rather than their market value.[816]

Notwithstanding these findings of fact and law, the Tribunal held that the claimant had a 'legitimate expectation of obtaining compensation (even if not necessarily a fully satisfactory compensation).' It agreed with the claimant that the compensation mechanism had been 'deprived of its value' and, therefore, held that the claimant's legitimate expectation had been breached.[817] To understand the Tribunal's reasoning, it is important to note that the principle that a contractual compensation term should not be 'deprived of its value' was not a principle of Moldovan contract law. The expectation of the claimant was a *business* expectation that existed independently of the terms of the agreement the claimant had made with the state.

The decision that most clearly articulates an interpretation of the doctrine of legitimate expectations based on the investor's business plans is *Bau v Thailand*. Bau was a minority investor in a Thai tollway project. The investment consortium invested under a concession contract, which required it to build the tollway and then allowed it to collect the toll on the road for 25 years.[818] Ten years into the project the terms of the concession were renegotiated, with the renegotiated agreement (MoA2) providing for an increase in the toll and the removal of an on-ramp. The Thai authorities subsequently refused to increase the toll,

[815] *Bogdanov v Republic of Moldova* Arbitral Award, 22 September 2005 3.

[816] ibid 13.

[817] ibid 17.

[818] *Bau v The Kingdom of Thailand* Award, 1 July 2009 [2.36].

citing the consortium's failure to remove the on-ramp.[819] Then, in further negotiations to which the claimant objected, the consortium agreed to a reduction in the toll in exchange for the settlement of other legal disputes with the authorities.[820] The claimant sold its stake in the consortium and claimed that its legitimate expectations had been breached by the failure of the authorities to increase the toll.

The Tribunal held that the state's failure to increase the toll had breached the claimant's legitimate expectation of a reasonable rate of return on its investment. It was explicit that these expectations stemmed from the claimant's business plans:

> The Respondent could not reasonably have expected that foreign investors would enter into an arrangement of the nature proposed, over such a long period, without being fairly confident of a reasonable rate of return on investment ...
>
> In spite of the fact that there was no guarantee by the Respondent of an explicit rate of return, the Tribunal considers that a reasonable rate of return – reasonable in all the circumstances, including the signing of MoA2 [which had the effect of reducing the expected rate of return] – was part of the Claimant's legitimate expectations and the failure to fulfil such a reasonable expectation was a breach of the Respondent's obligations.[821]

The Tribunal acknowledged that, as a question of Thai corporate law, the minority investor was bound by the decision of the consortium to consent to the toll reduction. However, it held that it would be unfair for this fact to preclude the claimant from recovering for breach of the FET standard.[822]

The Tribunal did not consider whether, in order to recover for breach of a legitimate expectation, a claimant had to rely on that expectation in making its investment. It would be

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[819] ibid [12.14].

[820] ibid [12.26]-[12.30].

[821] ibid [12.2]-[12.3].

[822] ibid [12.31].

difficult to reconcile Bau's expectation of a reasonable rate of return with such a requirement of reliance. The original concession agreement did not confer any entitlement on the consortium to an increase in the toll. In the quantum section of the award, the Tribunal stated that the claimant's legitimate expectations that had been breached were those that existed at the time of the signing of MoA2 in 1996.[823] The claimant's original investment in the consortium had been made ten years earlier and there was no evidence that it made any subsequent investment in reliance on MoA2, or the business plans it engendered.

5.5.3.2 Restatement of the business plan approach

These three decisions constitute a coherent, albeit expansive, interpretation of the doctrine of legitimate expectations. This interpretation can be restated in the following propositions. With respect to the scope of the doctrine:

1. An expectation may be based on the business plans of the investor if the host state knew or should have known of those plans.

With respect to the criteria by which *legitimate* expectations are identified:

2. Business plans must be reasonable to justify a legitimate expectation. However, a business plan is not unreasonable simply because it is premised on assumptions about the way the state will act in the future that are based neither on the legal rights of the investor; nor on the regulatory arrangement in force when the investment was made; nor on unilateral statement made by the state.

With respect to reliance:

3. It appears that a claimant may recover for a breach of an expectation even if did not rely on that expectation in making the investment.

[823] ibid [13.10].

5.5.4 Summary: the four interpretations of the legitimate expectations element of FET

This chapter has argued that the protection of investors' legitimate expectations is a recognised element of the FET standard. The preceding sections have categorised decisions dealing with this element according to their understanding of the scope of the doctrine of legitimate expectations. Decisions embody three different views of the basis for expectations protected by the FET standard:

i) Expectations must rest on specific rights that the investor has acquired under domestic law.
ii) In addition to i), expectations may rest on prior statements of government officials or on the prior regulatory framework.
iii) In addition to ii), expectations may rest on the business plans of the investor.

Decisions in which expectations may be based on unilateral statements and on the general regulatory framework at the time of the investment can be further divided into two coherent interpretations – a strict and a permissive approach. As such, this chapter has identified four distinct interpretations of the doctrine of legitimate expectations in the reasoning of arbitral awards:

i) The legal rights approach, in which legitimate expectations can only be based on legal rights vested in the investor.
ii) a. The strict conduct approach, in which legitimate expectations can be based on clear and specific unilateral statements made by the host state; or on general regulations in force at the time the investment was made, if the state has indicated that the regulations would not be changed.

b. The permissive conduct approach, in which legitimate expectations can be based on unilateral statements made by the host state that need not be clear and specific to the investor; or on general regulations in force at the time the investment was made.

iii) The business plan approach, in which legitimate expectations can be based on an investor's business plan, if the host state knew of those plans.

5.6 Procedural review of governmental conduct under the FET standard

This section examines decisions in which state liability under the FET standard turns on failure to meet procedural standards of conduct, excluding cases examining a state's procedural obligations associated with the conduct of judicial proceedings. (Such obligations are governed by the doctrine of denial of justice.) It is widely recognised in arbitral decisions that a state's failure to meet a minimum standard of procedural fairness in non-judicial conduct may breach its obligation to provide FET.[824] Academic commentators agree that the FET standard imposes procedural obligations on host states, whether these obligations are classified under the label of 'procedural propriety and due process',[825] 'regulatory fairness and transparency',[826] or simply 'transparency'.[827]

In comparison to the doctrine of legitimate expectations, the principles governing procedural review under the FET standard are relatively undeveloped. Few decisions have attempted to articulate complete accounts of the principles of procedural review. Nevertheless, there seems to be a degree of consensus around some fundamental propositions, including the propositions that: the obligation of due process in administrative

[824] eg *Waste Management II* (n 623) [98]; *Methanex* (n 470) pt IV ch C [12]; *Saluka* (n 165) [308].

[825] Dolzer and Schreuer (n 64) 142; Tudor (n 595) 162.

[826] Grierson-Weiler and Laird (n 635) 277.

[827] Newcombe and Paradell (n 152) 292.

conduct is lower than that required in judicial proceedings under the doctrine of denial of justice;[828] and that, while a failure to follow the procedural requirements of national law may make a breach of FET more likely, the determination ultimately involves the application of an international standard.[829]

There are also significant differences between decisions in their interpretation of the procedural element of the FET standard. In order to make sense of these differences, I organise arbitral jurisprudence around key decisions. Three interpretative approaches are identified in this way:

i) A narrow approach, based on *Genin*, in which procedural unfairness must be aggravated either by being intentional or by having led to an outcome that cannot be justified on substantive grounds for it to breach the FET standard;
ii) An intermediate approach, based on *Chemtura*, in which procedural unfairness is sufficient to breach the FET standard, but in which the intensity of review is lenient – requiring 'procedurally improper behaviour ... both serious itself and material to the outcome' of an administrative process;
iii) An exacting approach, based on the detailed set of procedural requirements outlined in *Tecmed*.

Each set of decisions is characterised as a coherent, if conceptually incomplete, interpretation of the scope of procedural review under the FET standard. While the majority of cases are broadly consistent with the intermediate approach, decisions that fall within the narrow and the exacting approaches deserve to be taken seriously, as they are forthright and unambiguous in proposing interpretations strikingly different from the intermediate approach. Moreover,

[828] *Thunderbird* (n 637) [200]; Richard Kreindler, 'Fair and Equitable Treatment - A Comparative International Law Approach' (2006) 3 Transnational Dispute Management 1, 14.

[829] *Thunderbird* (n 637) [194]; *ELSI* (n 682) [127].

the narrow approach remains relevant to current arbitral practice, having been applied in the recent *Glamis* decision.

Finally, some mention must be made of the relationship between the procedural element of the FET standard and principles governing compensation for breach of FET. While IITs do not generally specify the formula by which compensation for a breach of FET should be determined, tribunals have calculated damages on the basis of the principle laid down in *Chorzów Factory*:[830]

> [R]eparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed.[831]

The application of this principle in cases of procedural review is not straightforward. For example, consider a situation in which a domestic regulatory authority must determine whether an investor has satisfied the conditions required for the renewal of its licence to operate the investment. A state may be liable for breach of the FET standard if the procedure by which the authority determines whether to renew the licence fails to meet some minimum standard of fairness. However, it will not necessarily be the case that the investor's licence would have been renewed if fair procedures had been followed. Quantification of the extent of loss *caused* by the procedural unfairness would then raise issues of considerable conceptual difficult. These issues go well beyond the scope of this thesis. For present purposes, it is sufficient to note that, on a given set of facts, the compensation to which a claimant is entitled may be affected by whether the tribunal finds that the breach of FET resulted from procedural unfairness or some other element of the FET standard.

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[830] Lluis Paradell, 'The BIT experience of the Fair and Equitable Treatment Standard' in Federico Ortino and others (eds), *Investment Treaty Law: Current Issues II* (British Institute of International and Comparative Law 2007) 137.

[831] *Case concerning certain German interests in Polish Upper Silesia (Germany v Poland) (Claim for Indemnity)* PCIJ Rep Series A No 17, 47.

5.6.1 *Genin*: the narrow approach

The facts in *Genin v Estonia* concerned the revocation of the banking licence of an Estonian bank, EIB, in which the claimant was a major shareholder. The decision to revoke the licence was made on 'extremely technical' grounds. Authorisation to acquire shares in EIB had been granted to Eurocapital Group Company but EIB's share register showed that shares were acquired by Eurocapital Group Limited, which the regulator took to be a different and unauthorised entity.[832] The central question for the Tribunal was whether Estonia breached the FET standard by revoking the licence in a manner that was procedurally unfair.[833] In answering this question, the Tribunal also took into account the fact that EIB had previously failed to disclose information on the ultimate ownership of its shareholders, as it was required to do under domestic law.[834] The Tribunal found that:

> No notice was ever transmitted to EIB to warn that its licence was in danger of revocation unless certain corrective measures were taken, and no opportunity was provided to EIB to make representations in that regard.[835]

The decision to revoke the licence 'was made immediately effective, giving EIB no opportunity to challenge it in court before it was publicly announced.'[836]

The Tribunal held that, to breach the FET standard, conduct must fall 'far below international standards':[837]

> [A]ny procedural irregularity that may have been present would have to amount to bad faith, a wilful disregard of due process of law or an extreme insufficiency of action.'[838]

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[832] *Genin* (n 604) [359].

[833] ibid [357].

[834] ibid [351]-[357].

[835] ibid [358].

[836] ibid [364].

[837] ibid [367].

In the Tribunal's assessment, the conduct did not fall below this standard. It relied heavily on the finding that, regardless of the procedural failings, the decision to revoke the licence was *substantively* justified – 'ample grounds existed for the action'.[839] Moreover, it found no evidence that departures from 'generally accepted banking and regulatory practice' were intentional or in bad faith.[840]

This approach was reinforced by the *Glamis* Tribunal, which took a similarly restrained view of the procedural element of the FET standard. It accepted the US's argument that the FET standard does not impose a freestanding requirement of transparency.[841] The Tribunal went on to hold that Article 1105(1) of NAFTA imposed 'a floor, an absolute bottom, below which conduct is not accepted by the international community.' Procedural impropriety could only breach this standard if it constituted 'blatant unfairness, [or] a complete lack of due process' – something 'far beyond the measure's mere illegality, an act so manifestly arbitrary, so unjust and surprising as to be unacceptable from the international perspective.'[842]

The facts of the case did not provide the Tribunal with the opportunity to explore the threshold set by this adjective-enriched formulation. Among a patchwork of related claims, the claimant alleged that an official administrative re-interpretation of US mining law breached the FET standard because it did not comply with the requirements under US federal law to afford interested parties notice and the opportunity for comment.[843] The Tribunal held

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[838] ibid [371].

[839] ibid [367], similarly [361], [363].

[840] ibid [364], [371].

[841] *Glamis Gold* (n 514) [578], [605], [627].

[842] ibid [627], [626].

[843] ibid [771].

that this claim did not raise a live issue because, 'if there was a procedural error, it was corrected quickly and effectively through domestic channels' by the adoption of a new interpretation two years later.[844]

5.6.1.1 Restatement of the narrow approach

Genin and *Glamis* are united by the view that procedural unfairness will only breach the FET standard if it exceeds some very high threshold of seriousness. These decisions are defined by their examination of procedural conduct that *does not* breach the FET standard, rather than by detailed exploration of the forms of conduct that might be sufficiently extreme to cross the threshold of liability. Nevertheless, they provide enough guidance to outline a coherent interpretation of the procedural element of FET, one that is embodied in the following propositions:

1. To breach the FET standard, administrative action must amount to 'bad faith, a wilful disregard of due process of law or an extreme insufficiency of action.'
2. This requirement places only minimal procedural obligations on host states. It seems that procedural unfairness will only breach the FET standard if it is aggravated either by being intentional or by having led to an outcome that cannot be justified on substantive grounds.
3. There is no freestanding requirement of transparency under the FET standard. A failure to act transparently could only breach the FET standard to the extent it falls within still uncharted concepts such as 'extreme insufficiency of action'.

5.6.2 *Chemtura*: an intermediate approach

The NAFTA case *Chemtura* concerned a Canadian ban on pesticides containing lindane, the claimant was a producer of such pesticides. The events leading to the ban were triggered by

[844] ibid.

the US government's decision to prohibit the import of lindane-treated canola seed.[845] The Canadian Pest Management Regulatory Agency (PMRA) then launched a 'Special Review' of the use of lindane. The review took two years and reached the conclusion that the health risks to workers handling lindane-containing pesticides justified a Canadian ban of these products.[846] At the claimant's request, a government 'Board of Review' was established to review the decision of the PMRA. Its report recommended that the PMRA reconsider alternatives to mitigate the occupational-health issues relating to the use of lindane.[847] The PMRA then launched a re-evaluation process, to which the claimant made submissions. The re-evaluation confirmed the findings of the original Special Review and concluded with a letter to the claimant addressing the submissions it had made on alternative mitigation measures.[848]

The claimant made two principal allegations: that the Special Review was a sham, motivated by avoiding trade complications with the US rather than legitimate health and environmental concerns; and that the process of the Special Review was flawed.[849] The Tribunal dismissed the first claim on the facts.[850] However, it accepted that, even if the Special Review of lindane had been conducted in good faith, it could still have breached the claimant's right to procedural fairness under the FET standard.[851] It held that the review process should be assessed 'as a whole' taking into account the subsequent procedures that

[845] *Chemtura* (n 514) [13].

[846] ibid [21]-[29].

[847] ibid [35]-[40].

[848] ibid [41]-[45].

[849] ibid [133].

[850] ibid [143].

[851] ibid [145].

constituted 'an additional opportunity offered to the claimant to put forward its position.'[852] The claimant advanced a range of contentions, including that: it had not been given sufficient notice of the Special Review; it had not been given sufficient practical opportunities to make submissions; the Special Review did not incorporate adequate scientific evidence; and that the Special Review was not completed in a timely manner. The Tribunal found a degree of factual support for some of the claimant's contentions, particularly the argument that the claimant lacked opportunities to make submissions to the original Special Review. However, it felt that these facts did not reach the threshold of 'procedurally improper behaviour by the PMRA which was both serious in itself and material to the outcome of its inquiry' that would amount to a breach of the FET standard.[853]

Several other decisions are consistent with the threshold that procedural impropriety must be both serious in itself and material to the outcome of the proceedings to breach the FET standard. The Tribunal *AES v Hungary* held that:

> [N]ot every process failing or imperfection that will amount to a failure to provide fair and equitable treatment. The standard is not one of perfection. It is only when a state's acts or procedural omissions are, on the facts and in the context before the adjudicator, manifestly unfair or unreasonable (such as would shock, or at least surprise a sense of juridical propriety)... that the standard can be said to be infringed.[854]

The procedural element of the claimant's FET claim turned on an assessment of the procedures by which the government implemented regulated pricing in the electricity industry. While the Tribunal held that there were 'procedural shortcomings', the most serious being the tight deadlines for comment on the draft price decrees, it held that these did not rise

[852] ibid.

[853] ibid [148].

[854] *AES* (n 775) [38].

to the level of breaches of FET.[855] The Tribunal noted that claimants had been given an opportunity to comment on the draft decrees that would be applied to them; that, notwithstanding the tight deadlines, they had been able to make comments; that the Ministry considered the claimant's comments and, at times, had adjusted the decrees accordingly; and that the claimants had the opportunity to seek review of the process in Hungarian courts.[856]

In *Lemire v Ukraine* the claimant alleged that a series of administrative decisions relating to the award of radio licenses under tender were unfair.[857] In considering the claims, the Tribunal held that the FET standard did not place a general obligation on the licensing authority to provide reasons for its decisions.[858] However, the licensing authority repeatedly awarded licenses to politically-powerful individuals, notwithstanding the claimant's uncontested evidence that it better-satisfied the criteria for award of particular licenses.[859] In this context, the licensing body's failure to state reasons for its decisions was central to the Tribunal's decision that the licensing authority's decision-making procedures had breached the FET standard.[860]

In *Middle East Cement v Egypt* the procedure by which an administrative seizure and sale of a ship owned by the claimant was executed was deemed to have breached the FET standard. The serious procedural shortcoming in the case was that the authorities did not notify the claimant that the ship would be seized, even though claimant's and its lawyer's

[855] ibid [66].

[856] ibid [50]-[69].

[857] *Lemire v Ukraine (II)* (n 593) [315].

[858] ibid [394].

[859] ibid [384].

[860] ibid [419]-[420].

addresses were known to the authorities.[861] In *Waste Management II* the Tribunal agreed that the FET standard could be breached by 'a complete lack of transparency and candour in an administrative process.'[862] In *Thunderbird*, the facts of which are described above,[863] the Tribunal held that the procedure by which SEGOB had determined that Thunderbird's machines did not comply with gaming legislation satisfied the FET standard, as the claimant had been given an opportunity to be heard and present evidence.[864] In *PSEG v Turkey* the Tribunal held that 'continuous and endless' changes in the legislation governing an investment, and in the interpretation and implementation of that legislation by the Turkish authorities, breached the FET standard.[865]

5.6.2.1 Procedural fairness in contractual dealings?

Chemtura, *AES*, *Middle East Cement* and *Thunderbird* all concerned the degree of procedural fairness to which a claimant was entitled in administrative proceedings that directly affected the claimant's interests. Other decisions have considered whether these requirements extend to contractual dealings. The leading case on this point is *Bayindir*. The claimant argued that it had been denied a right to be heard in the Pakistani government's decision to terminate a contract with the claimant, a decision that had been made on the basis of the claimant's non-performance.[866] The Tribunal accepted that a lack of procedural fairness in administrative proceedings could breach the FET standard, but held that these procedural guarantees were

[861] *Middle East Cement v Egypt* ICSID Case No ARB/99/6, Award, 12 April 2002 [143].

[862] *Waste Management II* (n 623) [98].

[863] Text to n 743.

[864] *Thunderbird* (n 637) [198].

[865] *PSEG* (n 608) [250]-[254].

[866] *Bayindir* (n 576) [338].

not available in every situation.[867] A claimant was not entitled to be heard in a government's internal decision-making processes relating to the exercise of rights created by a contract.[868] Similarly, in *Biwater* the Tribunal held that the FET standard did not place a procedural obligation on the Tanzanian water-regulator to consider a proposal to modify an existing contract to the benefit of the claimant (and the detriment of the host state), as the claimant had no contractual right to renegotiation.[869]

On the other hand, a state's failure to follow the *procedures specified by the contract* in cancelling a contract with the investor was central to finding a breach of FET in *Rumeli v Kazakhstan*.[870] The Tribunal held that the conduct of an administrative review of the validity of the contract cancellation procedure constituted a further breach of FET as: the claimants were unable to present their position; and the review's finding of validity relied on different grounds to those that formed the basis for the original decision.[871]

An exception to the principle that a claimant is not entitled to procedural fairness in contractual dealings was articulated in the decision *Jan de Nul v Egypt*. The Tribunal held that the state's failure to disclose key contractually relevant information in pre-contractual negotiations could amount to a breach of FET.[872] On the facts, the Tribunal found that this failure of disclosure did not breach the FET standard as the claimant was on notice that it should rely on its own inquiries, and was in a position to ascertain the information.[873]

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[867] ibid [344].

[868] ibid [345].

[869] *Biwater* (n 485) [673].

[870] *Rumeli* (n 610) [615].

[871] ibid [617].

[872] *Jan de Nul* (n 650) [221].

[873] ibid [229].

Similarly, in *PSEG v Turkey*, the Tribunal held that 'evident negligence' on the part of the host state in contractual negotiations with the claimant breached the FET standard.[874] These two decisions can be read as imposing a requirement of procedural fairness in contractual negotiations broadly equivalent to the standard of procedural fairness required in administrative proceedings, as understood in *Chemtura*. Both decisions can be distinguished from *Bayindir* and *Biwater* on the basis that they did not impose procedural obligations on a state to enter into contractual negotiations, nor additional obligations relating to the performance of existing contracts.

5.6.2.2 A requirement of lawfulness?

A state's compliance with domestic law can be understood as one aspect of procedural fairness, as a requirement of lawfulness constitutes a constraint on the manner in which a state may exercise its powers. Several decisions have examined the extent to which the FET standard requires a host state to act lawfully. In the NAFTA case *ADF v US* the claimant alleged that an administrative authority's failure to comply with the terms of its empowering statute breached the FET standard.[875] The Tribunal held that 'something more than simple illegality or lack of authority under domestic law of a State is necessary' to breach the FET standard.[876] In another NAFTA case, *GAMI*, the claimant argued that the failure of the Mexican sugar industry regulator to fully implement the pricing and quota regulations that governed the industry breached the FET standard. The Tribunal held that a 'failure to fulfil the objective of administrative regulations without more does not necessarily rise to a breach of international law.'[877] It found that the claimant had not proved that the regulator had a

[874] *PSEG* (n 608) [246].

[875] *ADF* (n 619) [190].

[876] ibid.

[877] *GAMI* (n 623) [97].

'simple and unequivocal' duty to achieve the objectives of the regulatory regime, nor that regulator had made an '"outright and unjustified repudiation" of the relevant regulations.'[878] These two decisions are consistent with the threshold defined in *Chemtura* – that procedural unfairness, here a failure to comply with domestic law, must be both serious and material in order to breach the FET standard.

The extent of a requirement of lawfulness was further explored in the decision *Noble v Romania*. The Tribunal held that the FET standard precluded a state from treating an investment in an arbitrary manner.[879] It quoted the ICJ's decision in *ELSI* to explain that arbitrariness, in this context, referred to:

> Not so much something opposed to a rule of law, as something opposed to the rule of law. ... It is a wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety.[880]

The Tribunal held that commencement of insolvency proceedings against the claimant was not arbitrary, because the proceedings were 'initiated and conducted according to the law and not against it.'[881] The suggestion that unlawfulness must be wilful appears to introduce a requirement of intent. However, the following phrase – which affirms that arbitrariness includes action that surprises juridical propriety – appears to leave the possibility open that serious disregard of national law would breach FET, even if an intention to ignore national law were not established.

5.6.2.3 Transparency

Several tribunals have held that the FET standard imposes an obligation of transparency on host states. Discussion of 'transparency' in the reasoning of FET decisions is complicated by

[878] ibid [110], [103].

[879] *Noble Ventures* (n 654) [182].

[880] ibid [176], citing *ELSI* (n 682) [128].

[881] *Noble Ventures* (n 654) [178].

differences in the way the term is used.[882] Transparency is best understood as one aspect of the procedural element of the FET standard. While both commentators and tribunals have linked the requirement of transparency to the protection of legitimate expectations,[883] this association is not doctrinally sound. A state may change domestic law in a way that an investor did not anticipate and still inform the investor openly, promptly and clearly that the law has so changed. Such a situation could not be said to lack transparency (save, perhaps, in the narrow circumstance in which a state had concealed a prior intention to change the law). Conversely, a state may refuse to make new regulations publicly available – yet, if the content of such secret regulations were entirely consistent with an investor's expectations, such a situation could not be said to breach an investor's legitimate expectations.

The better view (doctrinally) of the requirement of transparency under the FET standard is that:

> [A]ll relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made under an investment treaty should be capable of being readily known to all affected investors.[884]

This is consistent with the threshold articulated in *Chemtura*. A state that did not make it possible for an investor to ascertain the content of the laws that applied to its investment would perpetrate a serious unfairness, material to the investor's ability to operate its investment. The Tribunal in *Champion Trading v Egypt* applied this understanding of transparency in a claim brought by a cotton company regarding administrative decrees that

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[882] Text to n 893.

[883] eg Dolzer and Schreuer (n 64) 133; Thomas Wälde, 'Energy Charter Treaty-based Investment Arbitration' (2004) 5 Journal of World Investment and Trade 373, 387; *Occidental* (n 204) [185].

[884] *LG&E Energy* (n 679) [128].

determined the sale price of cotton.[885] The Tribunal dismissed the claim, finding that the claimants 'were in a position to know beforehand all rules and regulations that would govern their investments for the respective [cotton] season to come.'[886]

5.6.2.4 Restatement of the intermediate approach

Chemtura concerned the degree of procedural fairness to which an investor is entitled in administrative proceedings that directly affected the claimant's interests. The threshold articulated in that decision is capable of explaining and justifying a number of other decisions concerning the procedural element of the FET standard. This set of cases provides the outline of a coherent interpretation of the procedural element of FET, one embodied in the following propositions:

1. Procedural unfairness will breach the FET standard if it is both serious in itself and material to the outcome of proceedings that directly affect the investor.
2. A state may breach this threshold without the procedural unfairness leading to an outcome that is substantively unjustified or irrational.
3. A state may breach this threshold without acting in bad faith.
4. The record as a whole, including the availability of recourse under domestic law, determines whether the threshold has been breached.
5. Whether administrative proceedings breach this threshold will depend on assessment of what is fair in the specific context, which may include review of: whether the investor was notified of proceedings and given an opportunity to be heard in them; whether proceedings were conducted according to the requirements of domestic law;

[885] The claimant originally framed this claim as a breach of the FET provision of the treaty, but later framed it simply as a breach of 'international law'. The Tribunal referred to a decision of the WTO Appellate Body and the *Tecmed* Tribunal's discussion of the FET standard in addressing the claim. *Champion Trading Company v Arab Republic of Egypt* ICSID Case No ARB/02/9, Award, 27 October 2006 [157]-[164].

[886] ibid [164].

whether decision-making was based on the consideration of evidence; whether reasons were given for the decision; and whether the decision was reached in a timely manner.

6. Investors are not entitled to procedural fairness in contractual dealings, save that if a state does enter contractual negotiations with an investor, it must conduct itself fairly in those negotiations.
7. A state's serious and material failure to comply with its own law will breach the FET standard.
8. The procedural element of FET includes a transparency requirement that laws that apply to an investment should be readily capable of being known.

5.6.3 *Tecmed*: an exacting approach

The facts of Tecmed have been described above.[887] In its decision, the Tribunal articulated a comprehensive conception of the FET standard, much of which addressed procedural requirements imposed by the standard. Portions of the relevant paragraph read:

> The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. ... The investor also expects the State to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments ...[888]

[887] Text to n 778.

[888] *Tecmed* (n 484) [154].

This Tribunal's reasoning has been criticised for failing to apply its statement of the law to the facts of the case.[889] While noting this criticism, there can be no doubt that the paragraph purported to lay down the Tribunal's understanding of the FET standard. It is introduced with the sentence '[t]he Arbitral Tribunal considers that this provision of the Agreement [the FET provision] ... requires the Contracting Parties to ...'.[890] The paragraph has also been cited as a statement of the content of the FET standard by other tribunals.[891] It may be that the Tribunal felt no need to chart the outer boundary of the legal standard it had articulated, as Mexico's conduct fell short of less exacting standards of conduct.

It is clear that the Tribunal's interpretation of the procedural element of FET is more exacting than that of the *Chemtura* Tribunal. The *Tecmed* Tribunal's language is unqualified: a state must act 'totally transparently'; '[a]ny and all state actions' should be lawful and consistent with the goals underlying the laws in question. In this way, the *Tecmed* Tribunal suggests that *any* finding of procedural unfairness would breach the FET standard. The obvious contrast with the *Chemtura* approach is the absence of a threshold of seriousness or materiality before the identified classes of unfairness rise to the level of breaches of FET.

5.6.3.1 Transparency

The *Tecmed* dicta focused closely on unfairness that results from a state's failure to act in a way that is 'free from ambiguity and totally transparent'.[892] This entails a more exacting obligation on host states than the requirement that laws be capable of being known.[893] An investor may know the law that applies to its investment, yet be faced with ambiguity, either

[889] Douglas, 'Nothing if Not Critical' (n 24) 28.

[890] *Tecmed* (n 484) [154].

[891] *MTD* (n 576) [114].

[892] *Tecmed* (n 484) [154].

[893] Text to n 862.

because the terms of the law are not sufficiently precise or because the law confers a degree of discretion on the authorities that administer it. On the facts of the case, the *Tecmed* Tribunal held that the 'ambiguity and uncertainty' relating to the legal situation of the landfill breached the FET standard.[894] This ambiguity did not stem from any lack of clarity about the conditions governing the claimant's licence, or the fact that the licence was – formally – only of one year's duration. Rather, the lack of transparency in the case stemmed from uncertainty about the way in which an administrative authority would exercise a discretion conferred by clear and certain general laws; specifically, the question of whether the investor's licence would be renewed.[895]

A similar understanding of the obligation of transparency under the FET standard was developed in *Metalclad v Mexico*.[896] One of the reasons for the Tribunal's decision that Mexico breached the FET standard was that it had failed to provide this degree of transparency.[897] Under Mexican law, which was readily capable of being known, it was not clear whether the approval of the claimant's landfill by federal authorities exempted the claimant from the normal requirement of obtaining a municipal construction permit.[898] The fact that the municipal construction permit was denied at a meeting 'of which Metalclad received no notice, to which it received no invitation, and at which it was given no opportunity to appear' constituted further grounds for the finding that Mexico had breached the FET standard.[899]

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[894] *Tecmed* (n 484) [172].

[895] ibid.

[896] *Metalclad* (n 271) [76].

[897] ibid [88].

[898] ibid [81]-[86].

[899] ibid [91].

5.6.3.2 Administrative proceedings

The *Tecmed* Tribunal did not explore the implications of its interpretation for the conduct of administrative proceedings in great detail. The Tribunal did find that the environmental agency: failed to give the investor reasonable notice that, in the agency's view, the investor was in breach of its licence conditions; and that it failed to inform the investor that this could constitute grounds for non-renewal of the licence.[900] The Tribunal did not consider whether these events would have constituted an independent breach of the FET standard.

Another case that held that procedural unfairness would breach the FET standard, without identifying a minimum threshold of gravity that such unfairness would need to exceed, is the early NAFTA decision *Pope & Talbot*.[901] The relevant facts concerned a Canadian government agency's 'verification review' of the investor's compliance with lumber regulations. The American investor was required to transport truckloads of documents to Canada for the review. Despite a request from the investor, the agency refused to consider holding the review at the claimant's offices in the US or to provide reasons justifying its refusal. The Tribunal characterised this conduct as placing a 'substantial and disruptive burden' on the claimant, a burden caused by agency's 'imperious insistence on having its own way.'[902] The Tribunal drew further support for its conclusion from the fact that the agency refused to disclose what legal authority (if any) entitled it to conduct a review.[903]

[900] *Tecmed* (n 484) [161].

[901] *Pope & Talbot, Award on the Merits* (n 163) [116]-[118].

[902] ibid [172]-[173].

[903] ibid [174].

While the claimant could have sought judicial review of these administrative actions,[904] the Tribunal did not consider that this weighed against a finding of liability.[905]

5.6.3.3 Procedural fairness in contractual dealings?

While the *Tecmed* decision did not discuss procedural fairness in contractual dealings, it is consistent with the exacting approach of *Saluka*. The principal finding in *Saluka* was that the claimant's investment (a bank) had not been treated as well as locally-owned banks.[906] However, the Tribunal made a further finding that the procedural unfairness suffered by the claimant constituted an *independent* breach of FET. The claimant's bank was struggling to meet the capital adequacy requirements necessary to remain solvent and was seeking to negotiate the terms of a bailout with the host state. The claimant had no legal entitlement to be bailed out, nor had it received assurances that it would be bailed out. The state made it clear from the outset that it would not gift funds to the claimant's bank unless the investor also injected new capital.[907] The bank subsequently failed.

> The Tribunal held that the FET imposed a procedural obligation:
>
> [T]hat the host State [take] seriously a proposal that has sufficient potential to solve the problem and deal with it in an objective, transparent, unbiased and even-handed way.[908]

The Tribunal found that the Czech Republic breached this obligation by declining to consider plans proposed by the investor in which the state would bailout the bank without the investor having to make any co-contribution.[909] The decision implies a duty on the state actively to

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[904] ibid [183].

[905] ibid [156]-[181].

[906] *Saluka* (n 165) [314]-[347].

[907] ibid [385], [396].

[908] ibid [363], [407].

[909] ibid [398].

consider (and to consider fairly) an investor's contractual proposals, even those that the state views as substantively unacceptable. This principle contrasts with the *Biwater* decision, which expressly rejected arguments that the FET standard imposes an obligation on host states to consider contractual proposals made by investors.[910]

5.6.3.4 Restatement of the exacting approach

The *Tecmed* decision articulated a clear and detailed interpretation of the procedural element of the FET standard. While the trend in recent jurisprudence has been towards less exacting interpretations of the procedural element of the FET standard, the key paragraph from *Tecmed* award remains influential and is still cited by arbitral tribunals with approval.[911] The decisions identified in this section provide a basic outline of an interpretation of the procedural element of FET that differs significantly from *Chemtura*, one embodied in the following propositions:

1. Procedural unfairness will breach the FET standard. A finding of unfairness is sufficient to breach the standard without any additional finding that the unfairness exceeds a threshold of seriousness.
2. The availability of further administrative or judicial recourse does not necessarily weigh against a finding of unfairness.
3. The FET standard imposes an exacting transparency obligation on host states. Not only must laws be capable of being known, but the policies that underpin them and the manner in which they will be applied to particular fact scenarios must also be capable of being known in advance.

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[910] Text to n 869.

[911] *Roussalis v Romania* ICSID Case No ARB/06/1, Award, 7 December 2011 [316]

4. The FET standard entails a procedural obligation on states to actively and fairly consider contractual proposals made by investors.

5.6.4 Summary: the three interpretations of the procedural element of FET

This chapter has identified three interpretations of the procedural element of the FET standard:

i) A narrow approach, based on the *Genin*, in which procedural unfairness must be aggravated either by being intentional or by having led to an outcome that cannot be justified on substantive grounds for it to breach the FET standard;

ii) An intermediate approach, based on *Chemtura*, in which procedural unfairness is sufficient to breach the FET standard if it is 'both serious itself and material to the outcome' of an administrative process;

iii) An exacting approach, based on the detailed set of procedural and transparency requirements outlined in *Tecmed*.

5.7 Substantive review of governmental conduct under the FET standard

Both tribunals and commentators agree that the FET standard places some substantive limits on government conduct. For example, in *Saluka* the Tribunal stated that the treatment of an investment must be 'reasonably justifiable by public policies' to comply with the FET standard.[912] The recent popularity, and potential breadth, of the doctrine of legitimate expectations has meant that fewer cases turn on the interpretation and application of the substantive element of the FET standard than would otherwise be the case. That said, no tribunal has questioned the notion that the FET standard places substantive limits on government conduct that are not derived from the investor's legitimate expectations. Academic commentators tend to organise their discussion of this substantive element under

[912] *Saluka* (n 165) [307].

the label of 'unreasonableness',[913] or 'arbitrariness' (using arbitrariness to mean absence of substantive justification).[914]

There is relative consensus as to the basic contours of the substantive element of the FET standard. It is agreed that:

1. An IIT tribunal has no general jurisdiction to review government conduct. The substantive element of the FET standard permits review of conduct that constitutes *treatment* of an investment.
2. The FET standard does not empower a tribunal to review the legal arrangements in place when the investor makes the initial investment (although it may review the subsequent exercise of a power or discretion conferred by a pre-existing law);[915] review is limited to review of the host state's conduct during the lifespan of an investment – for example, changes made to the laws and regulations governing the investment.
3. The standard of substantive review is, broadly, one of reasonableness: to comply with the FET standard state conduct must be justifiable by some rational objective and be a reasonable attempt to advance that objective.
4. The substantive element of the FET standard is an independent basis for liability. A sufficiently irrational measure will breach the FET standard even if it is introduced and applied through a fair procedure and does not upset an investor's legitimate expectations.

[913] Vandevelde, *Bilateral Investment Treaties* (n 114) 202.

[914] Salacuse (n 32) 240.

[915] *GAMI* (n 623) [91]; Dolzer, 'Fair and Equitable Treatment' (n 577) 102.

Despite consensus on these basic issues, there is disagreement as to the degree of scrutiny to which a tribunal should subject a state's choice of policy objectives. This disagreement is particularly evident in the way in which tribunals deal with the 'politicisation' of government decision-making, which I use as a fault line to identify to distinct strands of decisions. In one set of decisions, the politicisation of a measure is irrelevant to the assessment of whether it has a rational objective. In these decisions tribunals allow states a wide discretion to define the objectives of their public policy. I label this the margin of appreciation approach.[916] In a second set of decisions, 'political reasons' are contrasted to rational objectives.[917] In these decisions tribunals scrutinise the motivations for a government's conduct and, in effect, invoke a presumption that a politically motivated measure does not pursue a rational objective. I describe this as the politics-as-irrationality approach.

Prior to examining arbitral reasoning, it is important to note that some IITs contain provisions that specifically prohibit the impairment of an investment by 'arbitrary and discriminatory' or 'unreasonable and discriminatory' measures. In applying these provisions, tribunals also engage in substantive review of government conduct. This chapter examines decisions interpreting and applying these provisions only insofar as the tribunal in question held that arbitrariness or unreasonableness in breach of these provisions would *necessarily*

[916] I adopt the term 'margin of appreciation' from the jurisprudence of the European Court of Human Rights (ECHR). The ECHR allows states a margin of appreciation in its assessment of whether a given interference with property rights pursues a 'legitimate aim "in the public interest"', *James v UK* (1986) 8 EHRR 123 [50]; Yves Winisdoerffer, 'Margin of Appreciation and Article 1 of Protocol No 1' (1998) 19 Human Rights Law Journal 18, 19. However, I do not intend to suggest that the way these arbitral tribunals approach the question of the existence of a 'rational policy' is identical to the way the ECHR approaches the question of the existence of a 'legitimate aim "in the public interest"'. Nor do I intend to suggest that arbitral tribunals consciously imported this concept from the jurisprudence of the ECHR.

[917] Peterson was the first to note this contrast between the *AES* and *Biwater* decisions. Luke Eric Peterson, 'Hungary prevails in first of three Energy Charter Treaty (ECT) arbitrations over power pricing disputes; arbitrators affirm that "politics" is not a dirty word' (2010) <http://www.iareporter.com/articles/ 20100928_7> accessed 27 January 2011.

constitute a breach of FET. Some of the key decisions examining the substantive element of the FET standard – notably, *AES* and *Biwater* – are based on reasoning incorporated into the FET standard in this way.

5.7.1 The margin of appreciation approach

AES v Hungary concerned the reintroduction of regulated pricing in the electricity industry. The Tribunal held that this change in the regulatory framework would breach the FET standard if it was substantively unreasonable.[918] The Tribunal expression of this legal standard was clear and concise:

> 10.3.7 There are two elements that require to be analyzed to determine whether a state's act was unreasonable: the existence of a rational policy; and the reasonableness of the act of the state in relation to the policy.
>
> 10.3.8 A rational policy is taken by a state following a logical (good sense) explanation and with the aim of addressing a public interest matter.
>
> 10.3.9 Nevertheless, a rational policy is not enough to justify all the measures taken by a state in its name. A challenged measure must also be reasonable. That is, there needs to be an appropriate correlation between the state's public policy objective and the measure adopted to achieve it. This has to do with the nature of the measure and the way it is implemented.[919]

The Tribunal then assessed the three reasons Hungary argued had justified the reregulation of pricing. The first was that it was necessary to overcome electricity generators' refusal to reduce the capacity that they produced and sold to the state under existing contracts. The Tribunal held that the *aim* of forcing a private party to give up contractual rights could not, in itself, qualify as a rational public policy. It contrasted this to a situation in which pursuit of some other rational policy affects an investor's contractual rights, a situation that would be consistent with the rational objective requirement.[920] (At this point, it is

[918] *AES* (n 775) [9.3.37]-[9.3.38].

[919] ibid [10.3.7]-[10.3.9].

[920] ibid [10.3.13].

important to note that the contracts in question did not fix the price at which the state was required to purchase electricity, but only the volume of electricity that generators were entitled to sell to the state).[921] The second was that the measure was necessary for Hungary to comply with European law. The Tribunal accepted that this could be a rational policy, although, as concerns under European law had not crystallised until after the measure was introduced, they could not provide a rational justification for it on the facts of the case.[922] The third reason for reregulation was that 'in the absence of either competition or regulation' the generators' profits on the fixed-volume electricity sale contracts 'exceeded reasonable rates of return for public utility sales.'[923] The Tribunal held that it was:

> [A] perfectly valid and rational policy objective for a government to address luxury profits. And while such price regimes may not be seen as desirable in certain quarters, this does not mean that such a policy is irrational.[924]

Perhaps the most significant finding of the Tribunal related to the significance of the politicisation of electricity pricing, stemming from public opposition to the higher prices that resulted from unregulated pricing. The Tribunal held that:

> [T]he level of the generators' returns became a public issue and something of a political lightning rod in the face of upcoming elections.
>
> 10.3.23 However, the fact that an issue becomes a political matter, such as the excessive profits of the generators and the reintroduction of the Price Decrees, does not mean that the existence of a rational policy is erased.
>
> 10.3.24 In fact, it is normal and common that a public policy matter becomes a political issue; that is the arena where such matters are discussed and made public.[925]

[921] ibid [4.4]-[4.11].

[922] ibid [10.3.16].

[923] ibid [10.3.20].

[924] ibid [10.3.34].

[925] ibid [10.3.22].

Having accepted that redressing excessive profitability in one sector of the economy was a rational public policy objective, the Tribunal held that reregulating pricing was a reasonable way to achieve that objective.[926] The regulated price was set to allow investors an annual profit of 7.1% of the value of the investment.

A line of earlier decisions are consistent with the principles of substantive review under the FET standard articulated in *AES*. In these cases, the analysis of whether conduct is justified by a rational policy and the assessment of whether it is a reasonable attempt to achieve this policy are often closely intertwined. The early NAFTA decision in *SD Myers* held that:

> When interpreting and applying the "minimum standard", a Chapter 11 tribunal does not have an open-ended mandate to second-guess government decision-making. Governments have to make many potentially controversial choices. In doing so, they may appear to have made mistakes, to have misjudged the facts, proceeded on the basis of a misguided economic or sociological theory, placed too much emphasis on some social values over others and adopted solutions that are ultimately ineffective or counterproductive.[927]

While this analysis of substantive review is phrased in the negative, it is consistent with positive principles of *AES*. Similarly, in *Pope & Talbot*, the Tribunal held that adjustment of lumber quotas to the claimant's detriment did not breach the FET standard because it was a 'reasonable response to the difficulty with which it [the host state] had to deal'.[928]

In a more recent NAFTA decision, *Glamis Gold*, the Tribunal observed that 'it is not for an international tribunal to delve into the details of and justifications for domestic law.'[929] In isolation, this statement could be read as implying that the FET contains no substantive

[926] ibid [10.3.35].

[927] *SD Myers* (n 487) [261].

[928] *Pope & Talbot, Award on the Merits* (n 163) [125].

[929] *Glamis Gold* (n 514) [762].

element. However, the Tribunal went on to confirm that conduct with a 'manifest lack of reasons' would breach the standard.[930] By lack of reasons, the Tribunal meant lack of rational justification, not a failure to state reasons. It found that the host state had met this requirement because a new measure requiring backfilling of goldmines was 'rationally related to its stated [environmental] purpose and reasonably drafted to address its objectives.'[931] The Tribunal also addressed the fact that the new backfilling regulation appeared to be partially motivated by public opposition to the mine on environmental grounds. Indeed, one member of Californian legislature had stated as much.[932] The Tribunal held that the fact that the mine was politically contentious and the new measure had been designed to apply to it, did not foreclose the question of whether the measure had a rational policy objective:

> [E]ven if an individual [legislator] did single out the Imperial Project, it could be in the nature of describing a symbol that has come to represent the harm that the legislature is striving to remedy. Symbols often can serve as a rallying call for expedited action; if, however, this symbolic project is merely a very visible member of a larger class of projects that are viewed as harmful by the legislature, and which also are addressed by the subsequent litigation [sic], it cannot be said that this project alone was 'targeted.'[933]

The decision in *Merrill Ring* was unusual in that the members of the Tribunal were unable to agree on the interpretation of Art 1105(1) of NAFTA.[934] To sidestep this disagreement, the Tribunal applied both the interpretation of the FET standard asserted by the claimant and that asserted by the respondent to the facts.[935] It found that the host state had not breached either threshold. Nevertheless, the split reasoning of the Tribunal neatly

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[930] ibid [779].

[931] ibid [803].

[932] ibid [703]-[710].

[933] ibid [792].

[934] *Merrill & Ring* (n 623) [246].

[935] ibid [219].

encapsulates the difference between the two interpretations of the substantive element of FET identified in this thesis. The interpretation advanced by the host state echoed the *AES* decision. Applying this interpretation, the Tribunal held that encouraging local processing of timber was a rational policy objective, notwithstanding that it benefited the Canadian timber processing industry at the expense of the Canadian logging industry.[936] The lumber export quota system of which the claimant (a US investor in the Canadian logging industry) complained, was a reasonable attempt to encourage local processing.[937]

Two further decisions focus more closely on the second-stage of substantive review – the requirement that a measure be reasonable in relation to its objective. Discussing Argentina's response to its financial crisis, without specific reference to the FET standard, the *Metalpar* Tribunal held that:

> Except in very obvious situations, it is extremely difficult to determine at the time such decisions are made, and even some time afterwards, whether said decisions were the best they could have been. ... Resolving whether the actions taken by the Argentine Republic ... were correct and taken in a timely manner ... are discussions that go beyond this Tribunal's sphere of action.[938]

This decision suggests that reasonableness under the FET standard requires only a rational connection between the measure and the achievement of the policy objective pursued by the measure – an interpretation that is consistent with the *AES* Tribunal's requirement of an 'appropriate correlation' between means and ends.[939]

The same understanding of reasonableness – rational connection between means and ends – was applied in *Eastern Sugar*. The majority of the Tribunal held that two

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[936] ibid [236].

[937] ibid [237].

[938] *Metalpar* (n 729) [198]-[199].

[939] *AES* (n 775) [10.3.9].

reorganisations of the Czech sugar production quota, both of which disadvantaged the claimant relative to other producers, did not breach the FET standard.[940] In making these findings, the Tribunal implicitly accepted that reduction of the sugar quota in line with EC rules was a rational policy objective and that, while poorly designed and implemented, these two measures had a reasoned connection to the realisation of this objective.[941] It was only a third reorganisation of the quota, in which the claimant's quota was cut by more than the entire national quota reduction, that the Tribunal found could not be justified by this objective. The state offered no rational justification for the fact the burden was concentrated on the claimant.[942] A measure that *increased* other producers' quotas at the expense of the claimant had no rational connection with the objective of reducing the industry's total sugar production.

5.7.1.1 Restatement of the margin of appreciation approach

This set of decisions is best explained and justified by the doctrinal principles carefully articulated in *AES v Hungary*. To comply with the substantive element of the FET standard:

1. Conduct must be capable of justification by a rational policy; and be a reasonable attempt to achieve that policy.
2. A tribunal should show a high degree of deference to a state's choice of policies. The fact that a policy objective is highly politicised does not bear on the question of whether the objective is rational.
3. The assessment of reasonableness requires a rational connection between means and ends; it does not impose a requirement of proportionality or 'least restrictive means'.

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[940] *Eastern Sugar* (n 655) [277], [284]-[285].

[941] ibid [261], [290]-[291].

[942] ibid [336].

5.7.2 The politics-as-irrationality approach

In *Biwater* the Tribunal was required to apply an IIT provision prohibiting unreasonable or discriminatory measures. It cited the *Saluka* decision, as authority for the proposition that 'the standard of "reasonableness" has no different meaning than the "fair and equitable treatment" standard'.[943] The Tribunal held that the obligation of reasonableness, required equally by the FET standard and the prohibition on unreasonable measures, requires that government conduct 'bears a reasonable relationship to some rational policy'.[944] Stated at this level of generality, this interpretation of the substantive element of the FET standard is no different to that articulated in *AES*. However, when it came to apply the law to the facts, the Tribunal showed less deference to the host state's choice of policy objectives.

The case arose out of events relating to the termination of a Tanzanian water concession held by the claimant. The privatisation of the water supply and the poor performance of the concessionaire had become contentious political issues. Although the host state was entitled to terminate the concession on account of the claimant's defective contractual performance, the Tribunal held that the state's conduct up to the termination could not be justified by rational policies. The Tribunal identified a number of occasions on which the state's conduct lacked substantive justification, of which two are particularly relevant. On 13 May 2005, the Water Minister held a press conference at which he criticised the claimant's performance of the contract and announced that the contract had been terminated. On 17 May 2005 the Minister addressed the concession's staff and also claimed that concession had been terminated. While the Tribunal agreed that, by early May, the government had initiated the process necessary to terminate and that termination was

[943] *Biwater* (n 485) [692].

[944] ibid [693].

'inevitable', it found that the concession was not legally terminated until end of the contractual cure period on 24 June 2005.[945]

In this context, Tanzania argued that the premature claims of termination could be justified by the 'rational policy of keeping citizens apprised of matters that affect their lives.'[946] The Tribunal rejected this argument as an attempt to provide an 'ex post facto' justification for statements that were, in fact, politically motivated:

> The press conference exceeded the bounds of normal information, included severe criticisms of BGT [the claimant] which were at least in part clearly motivated by political considerations.[947]

In other cases tribunals have reviewed the justifications for government conduct, without explicitly identifying the standard as one of rationality. Nevertheless, these cases are consistent with rationality review in which politically motivated conduct is presumptively unreasonable. In *Merrill Ring* the Tribunal applied the two distinct interpretations of the substantive element of FET to the facts. In the application of the broader interpretation the Tribunal held that the investor was entitled to be free from 'interference from government regulations which are not underpinned by appropriate policy objectives.'[948] The Tribunal suggested that the objective of supporting an industry, when such support was to the detriment of another industry, would not be a rational policy objective.[949] Applying this interpretation, the Tribunal noted that the lumber regulations of which the claimant complained 'appear to be geared towards some sort of benefit to the local [timber processing]

[945] ibid [625]-[626].

[946] ibid [683], [686].

[947] ibid [696], [698].

[948] *Merrill & Ring* (n 623) [233].

[949] ibid.

industry.'[950] It also noted that the regulations were designed by an industry co-regulatory institution of which representatives of the timber processing industry were members. This politicised institution was contrasted with a 'truly independent body'.[951] Despite these criticisms, the Tribunal concluded that the FET standard had not been breached; a conclusion that is difficult to reconcile with the reasoning that precedes it.[952]

Azurix v Argentina, like *Biwater*, concerned the termination of a water concession operated by the claimant. The dispute arose out of a long running disagreement between the parties about tariffs and costs under the contract. The claimant sought to terminate the concession on the basis of non-compliance by the provincial government. The government denied that it was in breach and insisted that the claimant had abandoned the concession.[953] In its assessment of the facts the Tribunal accepted some of the claimant's contentions relating to the contract and rejected others; it did not make an ultimate finding of whether, under Argentine law, the claimant was entitled to terminate on the basis of the province's non-compliance.[954] Instead, the Tribunal resolved the FET claim by examining whether the province's conduct was justified. It held that Argentina had breached the FET standard because the positions taken by the water regulator in the dispute with the concessionaire were motivated by popular opposition to tariff increases: 'the tariff regime was politicized because of concerns with forthcoming elections'.[955]

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[950] ibid [226].

[951] ibid [228].

[952] ibid [226]-[230].

[953] *Azurix* (n 610) [374].

[954] ibid [225]-[261].

[955] ibid [375], [92], [378].

The Tribunal in *Tecmed*, the facts of which are described above, displayed a similar understanding of the substantive element of FET.[956] While the primary basis for the state's liability in the case was breach of the investor's legitimate expectations, the Tribunal also held that conduct 'arbitrarily revoking any pre-existing decisions or permits issued by the State' would breach the FET standard.[957] When it came to apply this element, the Tribunal noted that the environmental agency's decision not to renew Tecmed's operating permit was motivated by the fact the waste facility had become 'a nuisance due to political reasons relating to the community's opposition'.[958] Because the decision was motivated by political concerns it was not, in the Tribunal's view, justified by environmental or public health objectives.[959]

The *Biwater*, *Azurix* and *Tecmed* decisions all concluded with findings that the measure impugned in the case was not related to a rational policy. These awards had no need to continue to the second stage of analysis – whether the measure in question was reasonable in relation to a rational policy.[960] It is impossible to know whether they would have required a rational connection between means and ends or whether they would have adopted some other, perhaps stricter, understanding of reasonableness. As such, the legal content of this interpretation of the substantive element of FET is not yet fully-defined.

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[956] Text to n 778.

[957] *Tecmed* (n 484) [154].

[958] ibid [164].

[959] ibid [129]-[130]. This aspect of the *Tecmed* Tribunal's reasoning has been criticised in detail in, David Schneiderman, 'Investing in Democracy? Political Process and International Investment Law' (2011) University of Toronto Law Journal.

[960] *Biwater* (n 485) [693].

5.7.2.1 Restatement of the politics-as-irrationality approach

Of these four decisions only *Biwater* employs the language of rationality review. Nevertheless, it is clear that the *Merrill Ring*, *Azurix* and *Tecmed* Tribunals determined states' liability under the FET standard by reviewing the conduct of the host state on substantive grounds. In all these decisions the Tribunals sought to determine whether the host state's conduct was justified by a rational policy objective. These Tribunals (including *Biwater*) engaged in a more detailed examination of the objectives that did, in fact, motivate the conduct of the state in question than tribunals adopting the margin of appreciation approach. This distinction is clearly illustrated by the former's approach politically motivated conduct. None of these decisions explored the legal contours of the second-stage of substantive review: the requirement that a measure must bear a reasonable relationship to the rational policy that provides its justification. However, it is important to note that they did not purport to introduce requirements of proportionality or a 'least restrictive measure' test. According to these decisions, to comply with the substantive element of the FET standard:

1. Conduct must be capable of justification by a rational policy; and be a reasonable attempt to achieve that policy.
2. A tribunal should not defer to a state's choice of objectives. The fact that a policy objective is politicised creates a presumption that it is not rational.

5.7.3 Proportionality review of government conduct under the FET standard?

The Tribunal in *EDF v Romania* held that:

> [I]n addition to a legitimate aim in the public interest there must be "a reasonable relationship of proportionality between the means employed and the aim sought to be realized"; that proportionality would be lacking if the person involved "bears an individual and excessive burden."[961]

[961] *EDF* (n 470) [293].

As authority for the criterion of proportionality – a more stringent criterion than reasonableness – the Tribunal cited an arbitral award dealing with indirect expropriation and a decision of the European Court of Human Rights concerning expropriation. Neither is good authority for the proposition for which they were cited.[962] No other arbitral award has held that a measure must satisfy a proportionality requirement to comply with the substantive element of the FET standard, or, indeed, any element of the FET standard.[963] On these grounds the decision can be disregarded.[964]

5.7.4 Summary: the two interpretations of the substantive element of FET

This chapter has identified two interpretations of the substantive element of the FET standard. According to both interpretations, conduct must be capable of justification by a rational policy and be a reasonable attempt to achieve that policy. Neither approach is fully doctrinally developed, in that neither has developed a comprehensive theory of the objectives that are 'rational', nor a precise articulation of the standard of review demanded by the requirement of a reasonable connection between means and ends. However, each approach is sufficiently developed to identify a key point of contrast: the scope of states' freedom to define their own policy objectives as rational. The two approaches are:

i) a state is entitled to a margin of appreciation in its choice of policy objectives; and, specifically, politicisation of an objective does not indicate irrationality.

ii) a tribunal should scrutinise a state's choice of policy objective; and, specifically, politicisation of an objective does indicate irrationality.

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[962] ibid.

[963] In *Vivendi II* the Tribunal did conclude that actions the respondent's 'irresponsible, unreasonable and disproportionate' actions breached the FET standard. However, reference to proportionality was a response to the respondent's argument that the actions were 'responsible, proportionate and appropriate', not the result of a finding that the substantive element of the FET standard imposed a requirement of proportionality. *Vivendi II* (n 485) [7.4.26], [7.4.18].

[964] cf Montt (n 23) 357.

5.8 Conclusion

Section 5.2 of this chapter argued that decisions interpreting differently-worded FET provisions should be understood as one body of decisions interpreting the FET standard. The FET standard, as understood in these decisions, comprises a number of different elements, each of which is capable of operating as a quasi-independent liability rule. Having explained and justified the parameters of this chapter in Section 5.3, Section 5.4 argued that decisions interpreting the FET standard are best understood by dividing them into decisions concerning the legitimate expectations, procedural and substantive elements of the standard.

Section 5.5 showed that tribunals have interpreted the legitimate expectations element in four different ways: the legal rights approach; the strict conduct approach; the permissive conduct approach; and the business plan approach. Section 5.6 showed that tribunals have interpreted the procedural element of FET in three different ways: the narrow approach; the intermediate approach; and the exacting approach. Section 5.7 showed that tribunals have interpreted the substantive element of FET in two different ways: the margin of appreciation approach; and the politics-as-irrationality approach. This doctrinal analysis is an original and important contribution of this thesis to the understanding of arbitral reasoning under the FET standard. Each interpretation is sketched as a model level of protection, which might be explicitly adopted in future IITs. Chapter 7 applies the normative framework developed in Chapter 4 to evaluate the normative merits of adopting each level of protection.

Chapter 6 Indirect Expropriation

6.1 Introduction

The expropriation of foreign property has long been a subject of international law.[965] Clauses in US treaties requiring states to pay compensation if they expropriate foreign-owned property date from the mid-nineteenth century.[966] European states have espoused the position that customary international law requires a state to pay compensation for the expropriation of foreign property since at least that time.[967] While capital importing states have, at various points, resisted the notion that customary international law requires compensation for expropriation,[968] provisions guaranteeing foreign investors compensation for expropriation are included in almost every IIT.[969]

There is an exceedingly high degree of uniformity in the drafting of expropriation provisions of IITs.[970] Common formulations require host states to compensate foreign investors for both direct and indirect forms of expropriation.[971] Direct expropriation refers to a situation in which a state formally transfers or extinguishes an investor's title to property.[972] Direct expropriations are relatively easy to identify and seldom controversial. Indirect expropriation refers to a situation in which an investor's legal title is not extinguished but the

[965] Dolzer and Schreuer (n 64) 88.

[966] Kenneth Vandevelde, 'The Bilateral Investment Treaty Program of the United States' (1988) 21 Cornell International Law Journal 201, 205.

[967] Donald Shea, *The Calvo Clause* (University of Minnesota Press 1955) 13.

[968] Alwyn Freeman, 'Recent Aspects of the Calvo Doctrine and the Challenge to International Law' (1946) 40 American Journal of International Law 121, 121; UNGA Res 3171 (XXVIII) (17 December 1973); UNGA Res 3281 (XXIX) (9 December 1974).

[969] UNCTAD, *International Investment Agreements* (n 5) 19; Dolzer and Schreuer (n 64) 88.

[970] Andreas Lowenfeld, *International Economic Law* (2nd edn, Oxford University Press 2008) 559.

[971] eg NAFTA (n 9) art 1110(1).

[972] *Biwater* (n 485) [454]; *Continental Casualty* (n 738) [276].

actions of a state are, in legally significant respects, analogous to direct expropriation. Most government regulations, decisions and policies that affect foreign investments do not constitute indirect expropriation. However, with the occasional exception,[973] the text of IITs does not provide arbitral tribunals with any guidance on how to draw the boundary between these non-compensable government measures and indirect expropriation.[974]

This chapter seeks to understand and elucidate the different ways in which tribunals interpret the concept of indirect expropriation under IITs. I propose a basic taxonomy of the structures of enquiry that tribunals use to distinguish indirect expropriation from legitimate, non-compensable government measures. The taxonomy divides decisions between: those that look exclusively to the effects of the measure on the protected investment; those that define expropriation by its effects, subject to exceptions for measures with certain characteristics; and those that balance the effects on the investment and the characteristics of the impugned measure in determining whether an expropriation has occurred. This chapter then employs an inductive methodology to locate arbitral reasoning within the taxonomy. In this way, five alternative interpretations of indirect expropriation are identified. Each interpretation is sketched as a model level of protection, which might be explicitly adopted in future IITs. This analysis and classification is, in itself, an original contribution of this thesis. This classification also provides the basis for Chapter 7, which evaluates the five identified levels of protection on the normative grounds articulated in Chapter 4. This thesis does not seek to determine which interpretation of indirect expropriation is 'correct' on doctrinal grounds.

This chapter comprises six substantive sections. Section 6.2 examines the text of expropriation provisions of IITs. Section 6.3 introduces and justifies the taxonomy used to

[973] Text to n 1172.

[974] UNCTAD, *Investor-State Dispute Settlement and Impact on Investment Rulemaking* (United Nations 2008) 56; Rudolf Dolzer, 'Indirect Expropriation of Alien Property' (1986) 1 ICSID Review - FILJ 41, 56.

classify arbitral reasoning in this chapter. Section 6.4 examines arbitral decisions that define indirect expropriation exclusively by the effects of the measure in question; it identifies two distinct interpretations of indirect expropriation that look exclusively a measure's effects. Section 6.5 examines arbitral decisions that define legitimate, non-compensable regulation (measures that do not constitute indirect expropriation) by looking exclusively to the characteristics of a measure; it identifies one such interpretation. Section 6.6 examines arbitral decisions that identify indirect expropriation by balancing the effects and the characteristics of a measure; it identifies two distinct interpretations that employ this structure of enquiry.

6.2 Expropriation provisions of IITs

IIT expropriation provisions are normally drafted in a way that precludes the expropriation of foreign investments unless the host state satisfies certain conditions. The Australia-Mexico BIT is typical:

> Neither Contracting Party shall expropriate or nationalise an investment either directly or indirectly through measures tantamount to expropriation or nationalisation (hereinafter referred to as 'expropriation'), except:
>
> a) for a public purpose;
> b) on a non-discriminatory basis;
> c) in accordance with due process of law; and
> d) accompanied by payment of compensation ... [975]

Thus, IIT expropriation provisions incorporate three analytically distinct stages of legal enquiry. The first stage of enquiry determines whether given legal interests constitute 'investments' covered by the expropriation provision; the second stage, determines whether a given investment, identified in the first stage of the analysis, is expropriated by given government measures; and the third stage of enquiry determines whether an expropriation

[975] Australia-Mexico BIT (23 August 2005) art 7(1).

that has occurred satisfies the criteria of a legal expropriation specified in the treaty, including the criterion that compensation be paid.[976]

This chapter is concerned with the second stage of analysis: the way in which arbitral tribunals determine whether a measure constitutes indirect expropriation for which compensation is required. Within this second stage of analysis, the definition of the term 'measure' is seldom contentious. Tribunals appear to accept that any legislative, regulatory or administrative action by the state would amount to a measure.[977] Arbitral and academic attention focuses on whether given measures amount to indirect expropriation. Before entering this debate, a key preliminary issue is whether variations in the drafting of expropriation provisions of IITs are legally significantly, particularly the use of other terms in place of the term 'indirect expropriation'. I argue that this chapter is justified in abstracting from textual difference on the grounds that tribunals interpret differently drafted provisions as if they all embody a common legal concept of indirect expropriation.

Although this chapter focuses on the second stage of the expropriation enquiry, some brief discussion of the first and third stage of enquiry is also warranted, as tribunals' approaches to these questions influence their determination of whether an expropriation has occurred. This section considers questions relating to the characterisation of the 'investment' in indirect expropriation cases; and the significance of the requirements that an expropriation must satisfy in order to comply with an IIT.

6.2.1 Indirect expropriation and variation in treaty text

While the drafting of expropriation provisions is relatively uniform, there is a modicum of variation between provisions. The key issue, in the context of this chapter, is the words used

[976] Dolzer and Schreuer (n 64) 90.

[977] *Suez and Vivendi* (n 137) [131]; Newcombe and Paradell (n 152) 337.

to specify the type of government conduct that will trigger a state's obligation to pay compensation. A brief survey of expropriation provisions reveals a range of formulations. Article 1110 of NAFTA provides that '[n]o Party may directly or indirectly nationalize or expropriate an investment... or take a measure tantamount to expropriation...';[978] the ECT stipulates that investments 'shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation...';[979] Dutch BITs speak of 'measures depriving, directly or indirectly nationals of the other Contracting Party of their investments...';[980] and French BITs are sometimes translated as requiring compensation for 'measure[s] having an effect similar to dispossession...'.[981] This survey illustrates that IITs employ a variety of synonyms for the term expropriation – including 'nationalisation', 'deprivation' and 'dispossession'. It also reveals that expropriation provisions use different words to indicate that the provision applies to measures that are analogous to direct expropriation – including the phrases 'indirect expropriation', 'measures tantamount to expropriation', and 'measures having effect equivalent to expropriation'.

In general, arbitral tribunals have not given legal significance to the particular words an expropriation provision uses to refer to conduct analogous to direct expropriation. Rather, tribunals interpret differently-worded provisions as if they refer to a common concept of indirect expropriation. For example, tribunals regularly frame their analysis in terms of indirect expropriation,[982] even when the expropriation provision of the applicable IIT does

[978] NAFTA (n 9) art 1110(1).

[979] ECT (n 10) art 13(1).

[980] Netherlands-Mexico BIT (n 640) art 5(1).

[981] Argentina-France BIT (3 July 1991) art 5(2), as translated in *Vivendi II* (n 485) [7.5.1].

[982] eg *LG&E Energy* (n 679) [185].

not contain the words 'indirect expropriation'.[983] An example is tribunals' interpretation of Article 1110 of NAFTA. While, this provision could be read as requiring compensation for both indirect expropriation and a broader category of 'measures tantamount to expropriation', most tribunals have rejected the argument that the phrase tantamount to expropriation goes beyond the concept of indirect expropriation.[984]

One possible exception to this general disregard of textual nuance is tribunals' interpretation of provisions that require compensation for measures 'having an *effect* equivalent to nationalization or expropriation.'[985] The Tribunals in *National Grid v Argentina* and *Siemens v Argentina* argued that this treaty text requires measures analogous to direct expropriation to be identified exclusively by their effect on an investment.[986] However, most tribunals interpreting identical provisions have not given the 'effect equivalent' formulation special significance, holding instead that this phrase is synonymous with indirect expropriation.[987] Via this interpretative process, several tribunals have arrived at the conclusion that a measure's characteristics, as well as its effects, are relevant in determining whether a measure requires compensation under an 'effect equivalent to expropriation' provision.[988]

On these grounds, this chapter is justified as treating arbitral decisions that interpret differently worded provisions as comprising a single body of indirect expropriation cases.

[983] *BG Group* (n 613) [259]; *Tecmed* (n 484) [114].

[984] *Pope & Talbot, Interim Award* (n 615) [96]; *Feldman v Mexico* ICISD Case No ARB(AF)/99/1, Award, 16 December 2002 [100]; *SD Myers* (n 487) [286]; *Glamis Gold* (n 514) [355]; cf *Waste Management II* (n 623) [155].

[985] *National Grid* (n 608) [147], emphasis in original.

[986] ibid; *Siemens* (n 596) [270].

[987] *Telenor Mobile Communications v Republic of Hungary* ICSID Case No ARB/04/15, Award, 13 September 2006 [63]; *BG Group* (n 613) [259].

[988] *Tecmed* (n 484) [114]; *Suez and Vivendi* (n 137) [139]; *Suez and InterAgua* (n 647) [128].

This conclusion is buttressed by the frequency with which tribunals cite other arbitral awards that apply differently worded expropriation provisions.[989] It is also consistent with vast majority of academic writing.[990]

A final comment should be made on the terms 'de facto expropriation', constructive expropriation', 'creeping expropriation' and 'regulatory expropriation'. These terms rarely appear in the text of IIT expropriation provisions, but are sometimes used in academic writing.[991] To the extent tribunals have discussed these terms, they have found that de facto expropriation and constructive expropriation are synonymous with indirect expropriation.[992] The term creeping expropriation is more analytically useful:

> Creeping expropriation is a form of indirect expropriation with a distinctive temporal quality in the sense that it encapsulates the situation whereby a series of acts attributable to the State *over a period of time* culminate in the expropriatory taking of such property.[993]

As such, the concept of 'creeping expropriation' clarifies, rather than expands the concept of indirect expropriation. Likewise, the term 'regulatory expropriation' clarifies that a regulation

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[989] See, among others, *National Grid* (n 608) [148]-[155]; *Fireman's Fund Insurance Co v Mexico* ICSID Case No ARB(AF)/02/01, Award, 17 July 2006 [172]; *Telenor* (n 987) [63].

[990] Anne Hoffmann, 'Indirect Expropriation' in August Reinisch (ed), *Standards of Investment Protection* (Oxford University Press 2008) 153; August Reinisch, 'Expropriation' in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law* (Oxford University Press 2008) 420; Christoph Schreuer, 'The Concept of Expropriation under the ECT and other Investment Protection Treaties ' in Clarisse Ribeiro (ed), *Investment Arbitration and the Energy Charter Treaty* (JurisNet 2006) 114; Salacuse (n 32) 300; Newcombe and Paradell (n 152) 341; Dolzer and Schreuer (n 64) 96; McLachlan, Shore and Weiniger (n 635) 275; Montt (n 23) 231.

[991] Newcombe and Paradell (n 152) 432; Christina Knahr, 'Indirect Expropriation in Recent Investment Arbitration' (2009) 6 Transnational Dispute Management 1, 2; Burns Weston, '"Constructive Takings" under International Law' (1975) 16 Virginia Journal of International Law 103, 111.

[992] *Petrobart* (n 669) 77; *CME* (n 35) [604]; *Tecmed* (n 484) [114].

[993] *Generation Ukraine v Ukraine* ICSID Case No ARB00/09, Award, 16 September 2003 [20.22].

can amount to an indirect expropriation, rather than expanding the meaning of indirect expropriation.[994]

6.2.2 Indirect expropriation in customary international law

A number of academic writers have argued that the expropriation provisions of IITs codify customary international law, including the customary law that defines indirect expropriation.[995] If IIT provisions all embodied a common rule of customary international law, tribunals would be justified in overlooking differences in the wording that provisions use to refer to that common rule.[996] While noting that there are strong arguments for this view,[997] it is unnecessary for this chapter to determine whether the expropriation provisions of IITs embody customary international law, or to answer the related question of whether tribunals' handling of textual difference is justified. This chapter rests on observations about the way tribunals approach indirect expropriation provisions in practice.

6.2.3 What is an investment, and why does it matter?

IITs invariably designate the investments that fall within expropriation provisions.[998] The term 'investment' is usually defined broadly, to include both physical assets and intangible assets, such as contracts.[999] In this respect the ECT is typical. It defines 'investment' to mean 'every kind of asset, owned or controlled directly or indirectly by an Investor' and goes on to provide an extensive list of tangible and intangible assets that would fall within this

[994] Reinisch (n 990) 432; Salacuse (n 32) 297.

[995] Hoffmann (n 990) 154; Reinisch (n 990) 420; Newcombe and Paradell (n 152) 332; Montt (n 23) 232; cf Surya Subedi, 'The Challenge of Reconciling the Competing Principles with the Law of Foreign Investment with Special Reference to the Recent Trend in the Interpretation of the Term "Expropriation"' (2006) 40 The International Lawyer 121, 128.

[996] *SD Myers* (n 487) [280]; *Saluka* (n 165) [261].

[997] McLachlan, Shore and Weiniger (n 635) 286.

[998] UNCTAD, *International Investment Agreements* (n 5) 115.

[999] eg NAFTA (n 9) art 1139.

definition.[1000] One might think that such clear treaty definitions of the term 'investment' conclusively resolve any disagreement at the first stage of an expropriation enquiry. This is not so.

Conceptual problems arise when an investor owns a set of assets that might be characterised at a number of different degrees of generality, all of which would fall within the treaty definition of an investment.[1001] For example, many IITs expressly provide that a licence falls within the definition of an investment; a factory would also fall within the definition of an investment.[1002] If a host state repudiates an investor's licence to operate a factory, should the tribunal ask if the licence was expropriated, or whether the repudiation of the licence amounted to an expropriation of the factory? A tribunal's characterisation of a particular collection of assets pertaining to a single project as a number of distinct investments would make a finding of indirect expropriation more likely (admittedly, a finding that a more circumscribed investment had been expropriated). A tribunal's characterisation of the same collection of assets as a single investment would make a finding of expropriation less likely.[1003]

While arbitral tribunals have seldom engaged in detailed discussion of these conceptual issues,[1004] several decisions conform to the principle that, for the purpose of an

[1000] ECT (n 10) art 1(6).

[1001] This problem has been discussed in detail in US constitutional jurisprudence on regulatory takings. The US Supreme Court has, rightly, recognised that the severability of property rights poses a serious conceptual problem for expropriation jurisprudence – 'to the extent that any portion of property is taken [by a government measure], that portion is always taken in its entirety' *Concrete Pipe v Construction Laborers Pension Trust* 508 US 602 (1993) 644. The problem, then, is to identify the appropriate denominator against which the taking of a given set of legal rights (the numerator) should be compared. The US Supreme Court's solution is the parcel as a whole doctrine, *Penn Central* (n 384) 130.

[1002] ECT (n 10) art 1(6).

[1003] Vandevelde, *Bilateral Investment Treaties* (n 114) 280.

[1004] Lowe, *Changing Dimensions of International Investment Law* (n 62) 65.

indirect expropriation claim, a claimant's investment is its economic undertaking in a host state.[1005] For example, in *MCI Power v Ecuador* the claimant argued that its permit to operate as a company in Ecuador constituted an investment.[1006] Even though the US-Ecuador BIT included 'any right conferred by law or contract, and any licenses and permits pursuant to law' within the definition of an investment,[1007] the Tribunal held that the relevant investment was the claimant's business of installing and operating power plants in Ecuador.[1008] Similarly, in *Occidental v Ecuador* the Tribunal rejected the claimant's argument that its right under Ecuadorian law to a refund on taxes already paid was an investment,[1009] notwithstanding the fact that the definition of investment in the BIT included 'a claim to money or a claim to performance having economic value, and associated with an investment'.[1010]

Less controversially, tribunals have followed IIT definitions of the term 'investment' when these definitions provide textual support for the principle that a claimant's overall economic undertaking is the relevant investment. *Chemtura v Canada* concerned a factual scenario in which a government measure had severely affected one aspect of a claimant's business in a foreign country, while the other components of the business continued to operate profitably.[1011] The Tribunal held that the relevant investment was the claimant's

[1005] Ursula Kriebaum and Christoph Schreuer, 'The Concept of Property in Human Rights Law and International Investment Law' in S. Breitenmoser (ed), *Human Rights, Democracy and the Rule of Law* (Nomos 2007) 760.

[1006] *MCI Power* (n 606) [289].

[1007] US-Ecuador BIT (27 August 1993) art 1(1).

[1008] *MCI Power* (n 606) [300]; similarly, *Parkerings* (n 579) [455]; *Tecmed* (n 484) [117]; *Bogdanov* (n 815) [4.2.5].

[1009] *Occidental* (n 204) [86]. Similarly, *Nykomb Synergistics Technology Holding v Republic of Latvia* Award, 16 December 2003 [4.3.1]; *Metalpar* (n 729) [174].

[1010] US-Ecuador BIT (n 1007) art 1(1).

[1011] *Chemtura* (n 514) [258].

overall business, reflecting the NAFTA definition of an investment, which includes 'an enterprise',[1012] and the fact that the claimant had not been able to identify any narrower investment that fell within the NAFTA definition.[1013] (It is unclear whether the relevant investment would have been characterized differently if the affected component of the claimant's business had been carried out through a subsidiary corporation.)

In contrast to the decisions in *Occidental* and *MCI Power*, other tribunals have relied on the definition of 'investment' in the applicable IIT to characterise a single specific asset that comprised part of a wider economic undertaking as an investment capable of indirect expropriation. In *Middle East Cement v Egypt*, the Tribunal characterised the investor's licence to import cement as an investment capable of expropriation and subsequently concluded that the licence had been expropriated.[1014] Faced with essentially the same facts as *Occidental*, the Tribunal in *Encana v Ecuador* held that the right to a tax refund under Ecuadorian law was an investment capable of expropriation.[1015]

Comments made by the Tribunal in *GAMI v Mexico* might be read as further support for characterising the relevant investment narrowly, so long as such a characterisation falls within the definition relevant IIT. The Tribunal asked:

> Should *Pope & Talbot* [the principle that expropriation requires a substantial deprivation of property] be understood to mean that property is taken only if it is so affected in its entirety? That question cannot be answered properly before asking: what property? The taking of 50 acres of a farm is equally expropriatory whether that is the whole farm or just a fraction. The notion

[1012] NAFTA (n 9) arts 1139, 201(1).

[1013] *Chemtura* (n 514) [258]; similarly, *Feldman* (n 984) [111]; *Merrill & Ring* (n 623) [144]; *Grand River* (n 653) [152]; *Telenor* (n 987) [67].

[1014] *Middle East Cement* (n 861) [101], [107]; similarly, *Eureko* (n 656) [239]-[241]; *Waste Management II* (n 623) [163]; *Bayindir* (n 576) [442].

[1015] *EnCana v Republic of Ecuador* Award, 3 February 2006 [183].

> must be understood as this: the affected property must be impaired to such an extent that it must be seen as 'taken.'[1016]

It is doubtful whether the principle that the relevant investment is 'the affected property' provides much guidance in cases of *indirect* expropriation. Conceptual difficulties relating to the characterisation of the investment in indirect expropriation claims are qualitative, rather than the quantitative problems of characterisation discussed in *GAMI*. For example, if a host state repudiates an investor's licence to operate a factory, both the licence and the factory could reasonably be regarded as 'affected property'. In any case, *GAMI* can be distinguished from the decisions reviewed above on the grounds that the Tribunal was discussing an example of direct expropriation.[1017]

This review of arbitral practice reveals that arbitral tribunals are yet to develop a coherent doctrinal approach to the characterisation of the relevant investment in indirect expropriation claims.[1018] It also supports a cautious conclusion: tribunals tend to characterise an investor's economic undertaking in the host state as the relevant investment.[1019] Thus, when a tribunal that speaks of the 'effect' of a government measure that repudiates an investor's licence or the 'effect' of a restriction on the use of a physical asset it is normally referring to its effect *on the investor's business*. The examination in Sections D, E and F of the second stage of the expropriation enquiry – the stage in which a tribunal determines whether an expropriation has occurred – proceeds on the basis that this is the more common practice. Specific mention is made of decisions that characterises the relevant investment more narrowly.

[1016] *GAMI* (n 623) [150].

[1017] Vandevelde, *Bilateral Investment Treaties* (n 114) 281.

[1018] Montt (n 23) 268.

[1019] Vandevelde, *Bilateral Investment Treaties* (n 114) 280; Newcombe and Paradell (n 152) 350.

6.2.3.1 Can part of an investment be the subject of an indirect expropriation claim?

A subsidiary issue in the first stage of the expropriation enquiry is whether part of an investment may be the subject of an expropriation claim. The provisions of IITs are clear. Only interests that qualify as investments fall within the scope of treaty expropriation provisions; and, in resolving a claim that falls within the scope of an expropriation provision, a tribunal can only conclude that an investment in question was expropriated, or that the investment was not expropriated.[1020] The possibility of a state being liable for 'partial expropriation' must be rejected.[1021] Academic discussion of partial expropriation is best understood as drawing attention to two analytically distinct possibilities that are consistent with these textual foundations. The first is a situation in which a host state's interference with particular aspects of an investment is so significant that a tribunal would find that it amounts to an indirect expropriation of the entire investment, including the unaffected aspects.[1022] (Almost every claim of indirect expropriation is partial in this sense.) The second is a situation in which one component of a larger investment constitutes, in itself, an investment within the meaning of the applicable IIT.[1023] In this situation a tribunal could find the narrower investment had been expropriated, but that the broader investment had not.[1024]

6.2.4 The requirements for an expropriation to be legal, including compensation

IITs place conditions on states' right to expropriate foreign investments. Expropriation – of either the direct or indirect variety – will normally be permitted only if compensation is paid and if the expropriation is undertaken for a public purpose, in a non-discriminatory way and

[1020] cf Ursula Kriebaum, 'Partial Expropriation' (2007) 8 Journal of World Investment and Trade 69, 69; Dolzer and Schreuer (n 64) 108.

[1021] *Grand River* (n 653) [155].

[1022] *SD Myers* (n 487) [283].

[1023] Kriebaum, 'Partial Expropriation' (n 1020) 83.

[1024] This appears to be what the Tribunal meant in *Waste Management II* (n 623) [141].

complying with a minimum due process requirement.[1025] IITs usually specify that compensation should be equal to the market value of the investment.[1026] The enquiry into whether a measure constitutes an expropriation is logically prior to the question of whether these four requirements have been met;[1027] these requirements are of no immediate relevance to the determination of whether an indirect expropriation has occurred.[1028] In cases where a state has disputed an investor's claim of indirect expropriation, the state will invariably have failed to pay compensation for the purported expropriation. Thus, a textual reading of IITs suggests that a tribunal's finding of indirect expropriation will normally entail a further finding that the expropriation was illegal.[1029] Such a finding would render the other legality requirements moot.

This analysis raises the question of whether there is any difference between the remedial obligations attached to legal and illegal expropriations. The prevailing view in academic commentary is that, in contrast to the treaty-defined compensation required for a legal expropriation, an illegal expropriation requires a state to pay damages for breach of the treaty according to the principle laid down in *Chorzow Factory*:[1030]

> [R]eparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed.[1031]

[1025] UNCTAD, *International Investment Agreements* (n 5) 239.

[1026] August Reinisch, 'Legality of Expropriations' in August Reinisch (ed), *Standards of Investment Protection* (Oxford University Press 2008) 195.

[1027] *Fireman's Fund* (n 989) [174]; *Parkerings* (n 579) [456].

[1028] *Feldman* (n 984) [99].

[1029] Dolzer and Schreuer (n 64) 91.

[1030] Reinisch, 'Legality of Expropriations' (n 1026) 200; cf Audley Sheppard, 'The Distinction Between Lawful and Unlawful Expropriation' in Clarisse Ribeiro (ed), *Investment Arbitration and the Energy Charter Treaty* (JurisNet 2006) 195.

[1031] *Chorzow Factory* (n 831) 47.

However, in practice, there is seldom any difference between the amount of compensation required for a legal expropriation and the damages required for an illegal one.[1032] The reference-point for both is the market-value of the expropriated investment, which necessarily reflects its ability to generate future profits.[1033] For the purpose of this chapter, it is unnecessary to delve further into these issues, which have been the subject of detailed discussion elsewhere.[1034] It is sufficient to note that the remedial obligations associated with both legal and illegal expropriations are consistent with the characterisation of expropriation provisions as liability rules, with liability triggered by a finding of indirect expropriation.

6.3 The taxonomy

This section introduces and justifies the taxonomy used in this chapter to classify arbitral reasoning on indirect expropriation. The taxonomy divides decisions between those that distinguish indirect expropriation from non-compensable government measures by looking exclusively to the effects of the measure; those that define expropriation by its effects, subject to exceptions for measures with certain characteristics; and those that balance the effects on the investment and the characteristics of the impugned measure in determining whether an indirect expropriation has occurred. This section then confronts three objections that might be raised to the use of this taxonomy. The first is the objection that arbitral decisions on indirect expropriation can be explained and justified by a single jurisprudential theory. The second is the objection that each decision concerning indirect expropriation is uniquely tied to the facts of the case, with the result that these decisions are not amenable to abstract examination. The

[1032] One situation in which the standards diverge is in cases where the value of the investment has increased since the date of expropriation. For example, *ADC Affiliate v Hungary* ICSID Case No ARB/03/16, Award, 2 October 2006 [499].

[1033] Newcombe and Paradell (n 152) 381.

[1034] See generally, Irmgard Marboe, *Calculation of Compensation and Damages in International Investment Law* (Oxford University Press 2009).

third is the objection that decisions concerning the expropriation of contracts raise unique doctrinal issues, which prevents discussion of these decisions being assimilated with other cases of indirect expropriation.

6.3.1 The taxonomy used in this chapter

This chapter follows in a long line of academic scholarship that contends that arbitral decisions have interpreted the concept of indirect expropriation in different ways. Much of this scholarship divides decisions on indirect expropriation between those that focus exclusively on the effects of a measure and those that also consider its purpose.[1035] Application of this taxonomy has yielded important insights, notably, insight into deep-seated disagreement about whether an expropriation should be identified exclusively by its effects. Nevertheless, this taxonomy has two serious limitations. The binary nature of the taxonomy elides the analytical distinction between a legal enquiry in which a legitimate purpose conclusively characterises a measure as non-compensable and an enquiry in which a legitimate purpose is weighed against the measure's effect. This distinction is of significant practical importance.[1036] The second limitation is the use of the word 'purposes' to stand for everything that is not an effect. This tends to obscure the fact that tribunals have examined a range of measures' characteristics in determining whether the measure in question is an indirect expropriation.[1037]

[1035] For example Rudolf Dolzer, 'Indirect Expropriations' (2002) 11 New York University Environmental Law Journal 64, 79; Rudolf Dolzer and Felix Bloch, 'Indirect Expropriation' (2003) 5 International Law FORUM du droit international 155, 158; L.Yves Fortier and Stephen Drymer, 'Indirect Expropriation in the Law of International Investment' (2004) 19 ICSID Review - FILJ 293, 308; Martins Paparinskis, 'Regulatory Expropriation and Sustainable Development' in Marie-Claire Cordonier Segger, Markus Gehring and Andrew Newcombe (eds), *Sustainable Development in World Investment Law* (Kluwer Law International 2011) 300; Hoffmann (n 990) 156; *Azurix* (n 610) [309].

[1036] Contrast, *Methanex* (n 470) pt IV ch D [7]; with, *Tecmed* (n 484) [122].

[1037] eg *Fireman's Fund* (n 989) [176].

This chapter proposes a taxonomy that builds on the sole-effects/purposes taxonomy by addressing these two limitations. Indirect expropriation decisions fall within one of three possible structures of enquiry: [1038]

1. The enquiry could be directed exclusively to the effect of the measure on the protected property. An enquiry of this sort might look at: the effect of the measure on the rights of ownership; the effect of the measure on the value of the investment; or whether the investment is appropriated by some other party. These approaches share in common the structural characteristic that the legal enquiry is addressed solely to the effect on the investment. This is the 'effects' structure.
2. The enquiry could define expropriation exclusively by its effects, subject to exceptions defined exclusively by the characteristics of the measure in question. Determining whether a measure falls within the exceptions might involve consideration of any number of features of the measure and the manner of its application, including, but not limited to, the purpose of the regulation. This is the 'exception' structure.
3. The enquiry could consider both the effects on the investment and the characteristics of the impugned measure in determining whether an expropriation has occurred. A balancing rule of some sort would then be needed to mediate between the two sets of interests. This is the 'balancing' structure.

The categories of the taxonomy are mutually exclusive. Thus, decisions applying different structures of reasoning constitute different interpretations of indirect expropriation, unless they follow from a higher legal rule that allocates distinct classes of cases to different

[1038] Stern and Kriebaum both propose broadly similar taxonomies; Brigitte Stern, 'In Search of the Frontiers of Indirect Expropriation' in Arthur Rovine (ed), *Contemporary Issues in International Arbitration and Mediation* (Martinus Nijhoff 2008) 44; Kriebaum, 'Regulatory Takings' (n 80) 724.

structures of reasoning. At the same time, the taxonomy does not foreclose important questions of detail within each of the three possible structures of reasoning. This allows this chapter to identify points of disagreement between decisions that rely on the same structure of enquiry.

6.3.2 Can arbitral decisions be explained by a unified jurisprudential theory of indirect expropriation?

One objection that might be made to this taxonomy is that, notwithstanding apparent differences in their reasoning, all arbitral decisions on indirect expropriation can be explained and justified by a single jurisprudential theory. Several academic writers have attempted to construct such unified theories. The most prominent theories all contend that an indirect expropriation is defined by the effect of a measure, subject to certain, qualified exceptions. Different unified theories explain the nature of the qualified exceptions in different ways: Paparinskis argues that there is an exception for regulatory measures, subject to the condition that they are applied with due process;[1039] Newcombe and Paradell argue that there are exceptions for measures for the purpose of public order, health and the environment and taxation, subject to proportionality and reasonableness review;[1040] and Montt argues that there are exceptions for the 'termination of investments according to law' and for measures advancing 'pre-eminent public interests', both of which are subject to further counter-exceptions.[1041]

There are two initial difficulties with these unified theories. The first is that only a fraction of tribunals have articulated the test for indirect expropriation in the terms proposed by each theory. This observation is not conclusive – it could be that tribunals' reasoning can

[1039] Paparinskis (n 1035) 315.

[1040] Newcombe and Paradell (n 152) 358.

[1041] Montt (n 23) 273.

be reconciled to principles that they do not expressly articulate – but it does indicate the scale of the challenge that confronts attempts to construct a unified theory. The second difficulty is decisions in which a finding of liability for indirect expropriation rests exclusively on an analysis of the effects of the measure in question. It is arguable that some such decisions failed to discuss exceptions to expropriation because no exception was arguable on the facts.[1042] However, in other decisions, tribunals have expressly rejected the argument that consideration of a measure's characteristics is ever relevant.[1043] It is not possible to reconcile such decisions with any of the theories discussed above.

In the light of these difficulties with unified theories, the taxonomy proposed in this chapter provides a useful heuristic to frame inductive enquiry. This inductive enquiry, in turn, can help elucidate differences and similarities in the interpretation of indirect expropriation – a methodology that provides the basis for further reflection on the explanatory power of unified theories. Relying on this methodology, the subsequent sections of this chapter justify the conclusion that tribunals have interpreted the concept of indirect expropriation in a number of identifiably distinct ways that cannot satisfactorily be reconciled by a single jurisprudential theory.

6.3.3 Fact specific reasoning and indirect expropriation

Another objection that might be made to the taxonomy is that each arbitral decision should be understood as being uniquely tied to the facts of the case in question. This argument finds its most coherent expression in claims that there is no 'magical formula, susceptible to mechanical application' that can identify indirect expropriation; that arbitrators must, and do,

[1042] Paparinskis (n 1035) 311.

[1043] eg *Siemens* (n 596) [270].

'exercise their judgment in each case'.[1044] On this basis, one might attribute apparent inconsistencies in arbitral reasoning to factual nuances of the cases in question, rather than see them as evidence of different understandings of the legal content of indirect expropriation.

This objection can be addressed simply. There is no doubt that identifying an indirect expropriation requires an exercise of judgement specific to the factual nuances of the case in question. However, tribunals have taken remarkably different positions about which facts are relevant, and which facts are irrelevant, in the exercise of their judgement. These different interpretations of the legal content of indirect expropriation exist prior to an assessment of the facts in a given case. The subsequent sections of this chapter constitute a sustained argument for these propositions.

6.3.4 Are decisions dealing with the expropriation of contracts distinct?

Both arbitral tribunals and academic writing accept that contracts can be the subject of expropriation claims under IITs.[1045] This reflects the definition of the term 'investment' in IITs, which normally includes contracts.[1046] The text of IITs provides no reason to think that different legal principles govern the question of whether a contract has been expropriated. However, in practice, claims that an investor's contract with the host state has been expropriated raise unique factual issues: the state is both the counter-party to the contract and the governmental authority with the power to alter the law and regulations governing the contract.

[1044] Paulsson, 'Indirect expropriation' (n 125) 1; also, Jan Paulsson and Zachary Douglas, 'Indirect Expropriation in Investment Treaty Arbitrations' in N Horn (ed), *Arbitrating Foreign Investment Disputes* (Kluwer Law 2004) 146; Lowe, *Changing Dimensions of International Investment Law* (n 62) 76; *Generation Ukraine* (n 993) [20.29].

[1045] Dolzer and Schreuer (n 64) 116; *SPP* (n 704) [164]-[167].

[1046] UNCTAD, *International Investment Agreements* (n 5) 118.

Tribunals have been anxious to draw a distinction between a state's breach of a contract with an investor and the expropriation of the contract. In order to draw this distinction many tribunals distinguish between a state's behaviour 'as a party to the contract' and a state's exercise of 'superior governmental power'.[1047] For the actions of a state to expropriate a contract it is necessary, but not sufficient, that its actions involve the exercise of governmental power. While the distinction between the two types of behaviour is not always clear cut,[1048] the basic principle underpinning it is that a state does not expropriate an investment by breaching a contract in a way that any private party might have done.[1049] This doctrinal principle is specific to the expropriation of contracts.

In the context of this chapter, the issue is whether decisions concerning the expropriation of contracts can be analysed alongside decisions concerning the expropriation of other investments. In my view they can.[1050] The principle that only exercises of governmental authority can expropriate a contract can be explained and justified by general principles governing expropriation. A breach of contract, whether by a private party or a state acting as a private party, does not deprive an investor of its rights under the contract, as these rights still exist and can be enforced through a court of the host state.[1051] Nor does a breach deprive the investor of the value of the contract, as the rights under the contract subsist, including any attendant rights to damages for defective performance. Regardless of the way one interprets the concept of indirect expropriation, it is clear that a breach of contract does not, of itself, amount to an indirect expropriation. On the other hand, when a state enacts a

[1047] *Siemens* (n 596) [248], [253]; *Parkerings* (n 579) [433]; *Consortium RFCC v Morocco* ICSID Case No ARB/00/6, Award, 22 December 2003 [65].

[1048] Salacuse (n 32) 304.

[1049] *Waste Management II* (n 623) [174].

[1050] Similarly, *Suez and InterAgua* (n 647) [140]; cf Paparinskis (n 1035) 311.

[1051] *Waste Management II* (n 623) [175].

law declaring that its obligations under a contract cease to exist, it extinguishes the investor's rights in the investment, as well as the value of those rights.[1052] All interpretations of the concept of indirect expropriation would recognise that this conduct is potentially expropriatory. As such, the fact that an expropriation claim involves a contract does not alter the set of basic legal questions that confront a tribunal.

Moreover, in determining whether a contract has been indirectly expropriated, arbitral tribunals rely on the same range of interpretative approaches as tribunals faced with claims of the indirect expropriation of other types of investment. Some tribunals look to whether the state's action has seriously diminished the value of the contract;[1053] some examine whether the rights in the contract were destroyed;[1054] and others ask whether the interference with the contract was proportionate.[1055] The combination of common basic principles and shared approaches to points of interpretative disagreement is sufficient grounds for subsuming the discussion of the indirect expropriation of contracts into wider discussion of indirect expropriation.

6.4 The effects structure of enquiry

This section examines arbitral decisions that hold that an indirect expropriation should be *exclusively* by its effects. Several academic writers have argued that this is the correct view, both under IITs and as a matter of customary international law.[1056] This section identifies two

[1052] Vandevelde, *Bilateral Investment Treaties* (n 114) 303.

[1053] *Vivendi II* (n 485) [7.5.34].

[1054] *Biwater* (n 485) [464].

[1055] *Azurix* (n 610) [311]-[315].

[1056] With respect to IITs, W. Michael Reisman and Robert Sloane, 'Indirect Expropriation and its Valuation in the BIT Generation' (2003) 74 British Yearbook of International Law 115, 121; Schreuer, 'The Concept of Expropriation' (n 990) 153; Vandevelde, *Bilateral Investment Treaties* (n 114) 296; with respect to customary international law, Rosalyn Higgins, 'The Taking of Property by the State' (1982) 176 Recueil des Cours de l'Académie de Droit International 259, 331.

interpretations of indirect expropriation that turn exclusively on a measure's effects: one following from the decision of *Metalclad v Mexico* that looks to the loss of economic value of the investment caused by a measure; the other from *Pope & Talbot v Canada* that looks to the extent to which a measure interferes with the claimant's property interests in the investment.[1057] While both *Metalclad* and *Pope & Talbot* are relatively early decisions, the approaches they outline have been affirmed, applied and developed in more recent arbitral awards. On this basis, the award in the recent *Chemtura* case observed that two different lines of indirect expropriation jurisprudence have developed, which have their roots in the *Metalclad* and *Pope & Talbot* decisions respectively.[1058]

6.4.1 The *Metalclad* approach: effect on economic value

Metalclad had purchased a site in Mexico on which to build a hazardous waste landfill. It obtained the permits to operate the landfill from both state and federal agencies and had been told by federal officials that it did not need any additional authorisations.[1059] When construction was well under way, the Municipality issued a stop work order, claiming a municipal construction permit was also required. The Municipality ultimately refused to grant the permit and, despite having been completed in the interim, the landfill could not begin operation.[1060] Metalclad alleged that the Municipality's refusal to issue the permit expropriated its investment. After Metalclad had initiated proceedings, the state governor issued an 'Ecological Decree' establishing a Natural Area for the protection of rare cacti. The

[1057] *Metalclad* (n 271); *Pope & Talbot, Interim Award* (n 615).

[1058] *Chemtura* (n 514) [249].

[1059] *Metalclad* (n 271) [30]-[44].

[1060] ibid [46]-[62].

Area encompassed Metalclad's landfill and 'effectively and permanently precluded [its] operation'.[1061] The Ecological Decree was the basis for a second, distinct expropriation claim.

In evaluating the denial of permit claim, the Tribunal defined expropriation as 'covert or incidental interference with the use of property which has the effect of depriving the owner in whole or in significant part of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the state.'[1062] The legal equivalence of covert and incidental interference in the *Metalclad* decision implies that the characteristics of a measure are irrelevant. Covert interference suggests measures calculated to expropriate a particular investment by pretence of form. On the other hand, incidental interference includes the inadvertent effect of general regulations pursuing some other objective in good faith. The Tribunal was more explicit in evaluating the second claim. It held that it 'need not decide or consider the motivation or intent of the adoption of the Ecological Decree'.[1063] The Ecological Decree was an expropriation, on the basis that it 'had the effect of barring forever the operation of the landfill'.[1064]

The definition of expropriation provided by the *Metalclad* Tribunal refers to incidental interference with the *reasonably-to-be-expected benefits* of an investment. This approach focuses the enquiry on the effect of loss of economic value attributable to a measure, independently of any examination of the degree of interference with the investor's legal rights or entitlements relating to the investment. The decision suggests that an investor may reasonably expect future economic benefits that follow from the assumption that a state

[1061] ibid [58]-[59].

[1062] ibid [103].

[1063] ibid [111].

[1064] ibid [109].

will act consistently with any prior unilateral representations it has made to the investor.[1065] The Tribunal did assert that Metalclad was denied the 'the right to operate the landfill',[1066] but this assertion was not based on a determination of the powers of Mexican municipalities to issue construction permits under Mexican law.[1067]

The reasoning of the *Metalclad* decision was criticised on review by the Supreme Court of British Columbia.[1068] In reviewing the second expropriation finding the judge noted that 'the Tribunal gave an extremely broad definition of expropriation for the purposes of Article 1110... [which was] sufficiently broad to include a legitimate rezoning of property'.[1069] Despite these doubts, he held that the legal test for regulatory expropriation concerned a question of law that the reviewing court did not have jurisdiction to revisit.[1070]

6.4.1.1 Subsequent decisions applying the Metalclad *approach*

In *CME v Czech Republic*, a Dutch media investor challenged changes made to the regulatory regime governing the foreign ownership of television broadcast licences in the Czech Republic. The case was argued on the basis that the changes allowed the claimant's local business partner to alter its contractual relationship with the claimant, undermining the value of the claimant's business. The key finding of fact was that the media regulator eliminated the legal protection of the use of the licence, allowing the investor to lose the exclusive use of the licence at a later point.[1071]

[1065] ibid [107].

[1066] ibid [105].

[1067] ibid [86]; Lowe, *Changing Dimensions of International Investment Law* (n 62) 64.

[1068] *Mexico v Metalclad* (n 614) [68]-[83].

[1069] ibid [99].

[1070] ibid.

[1071] *CME* (n 35) [599].

The Tribunal began its discussion of expropriation by asserting that measures 'that effectively neutralize the benefit of the property, are subject to expropriation claims'.[1072] The Tribunal found that the facts in question amounted to regulatory expropriation because the government's actions 'destroyed... the commercial value of the investment'.[1073] The focus on the commercial value of the investment, independently of any analysis of the legal rights of which the investor had been deprived, was justified on the authority of *Metalclad*.[1074] In a single paragraph, the *CME* Tribunal acknowledged that 'deprivation of property... must be distinguished from ordinary [regulatory] measures in the proper execution of the law'.[1075] However, the Tribunal did not articulate any basis for indentifying ordinary regulatory measures, other than the absence of economic loss that would constitute indirect expropriation.

While *Metalclad* is one of the earlier decisions under an IIT, the approach outlined in the award has been endorsed and developed in the more recent decisions *Tokios Tokeles v Ukraine* and *Vivendi v Argentina (II)*.[1076] In *Vivendi II* the Tribunal applied the *Metalclad* approach to resolve a case in which the investor alleged the expropriation of a water concession contract. The Tribunal sought to determine whether the concession had been rendered valueless by the state's actions, rather than examining whether these actions had breached or extinguished the rights of the claimant in the concession. On this basis, the Tribunal found that the provincial government's public announcement, which had the effect

[1072] ibid [604]-[608].

[1073] ibid [591].

[1074] ibid [606].

[1075] ibid [603].

[1076] *Tokios Tokelés* (n 667) [120]; *Vivendi II* (n 485) [7.5.34].

of discouraging water consumers from paying their bills, indirectly expropriated the concession.[1077]

Other more recent decisions have used the *Metalclad* approach differently. In *Occidental v Ecuador* the Tribunal held that it need not elect between competing interpretations of indirect expropriation. It accepted that *Metalclad* established a 'rather broad' legal test for indirect expropriation, but held that the measure in question would not be expropriatory, even under the *Metalclad* test.[1078] The *Metalclad* approach was similarly applied, without being accepted, in *Waste Management v Mexico, Chemtura v Canada* and *Telenor v Hungary*.[1079] In this way the approach continues to play an important role in shaping current arbitral jurisprudence.

6.4.1.2 Restatement of the Metalclad *approach*

The *Metalclad* approach looks exclusively to the effects of a measure. A measure that causes an investment to lose significant economic value will amount to a regulatory expropriation, independently of an assessment of the measure's interference with legal rights in the investment. Removing the disjunctives, 'incidental interference with the use of property which has the effect of depriving the owner... in significant part of... reasonably-to-be-expected economic benefit of property' establishes expropriation.[1080] This loss of economic value may, but need not, be attributable to interference with an investor's legal rights and

[1077] *Vivendi II* (n 485) [7.5.28].

[1078] *Occidental* (n 204) [87].

[1079] *Waste Management II* (n 623) [154], [159]; *Chemtura* (n 514) [249], [263]; *Telenor* (n 987) [67].

[1080] *Metalclad* (n 271) 103.

entitlements in the investment. *Tokios Tokeles* described the standard as requiring deprivation 'of a "substantial" part of the value of the investment.' [1081]

6.4.2 The *Pope & Talbot* approach: substantial deprivation of property interests

In *Pope & Talbot* the investor challenged the introduction of Canada's Export Control Regime, which imposed a quota on the investor's export of softwood lumber to the US. The Tribunal described the ability to export lumber as a 'property interest' pertaining to the claimant's investment, a wood products company.[1082] To determine whether this interference with the entitlement had previously had under Canadian law to export lumber amounted to an expropriation, the Tribunal examined whether it was 'sufficiently restrictive to support a conclusion that the property has been 'taken' from the owner'.[1083] The Tribunal restated the standard: 'expropriation requires a substantial deprivation', making it clear that the test of 'taking' refers to the effects of the measure. The Tribunal rejected the investor's claim because, while it suffered reduced profits, the measure did not destroy the claimant's ability to 'use, enjoy or dispose of the property';[1084] Pope & Talbot retained full rights of ownership and control over its business.[1085]

The *Pope & Talbot* standard of substantial deprivation of an investor's property interests in the investment has been widely cited since. A number of cases invoking balancing and exception structures require an effect of substantial deprivation before the balancing or

[1081] *Tokios Tokelés* (n 667) [120].

[1082] *Pope & Talbot, Interim Award* (n 615) [4], [98].

[1083] ibid [102].

[1084] ibid, citing American Law Institute, *Restatement of the Law Third - The Foreign Relations Law of the United States*, vol 2 (American Law Institute Publishers 1987).

[1085] *Pope & Talbot, Interim Award* (n 615) [100]-[101].

exception question arises.[1086] The basis for treating *Pope & Talbot* as authority for an effects structure of enquiry is the Tribunal's statement that Article 1110 of NAFTA 'does cover non-discriminatory regulation that might be said to fall within the exercise of a state's so-called police powers'.[1087] However, the Tribunal did accept that 'special care' should be taken when reviewing the state's exercise of police powers.[1088] The *Pope & Talbot* decision did not indicate what special care would involve.

6.4.2.1 Subsequent decisions developing the Pope & Talbot *approach*

While *Pope & Talbot* is one of the earlier decisions under an IIT, the approach outlined in the award has been developed, by sharpening the distinction between a deprivation of property interests and an effect on the economic value of an investment. There is a degree of variation in terminology among these decisions; some speak of deprivation of 'property rights', or simply 'rights',[1089] rather than deprivation of 'property interests'.[1090] This variation in terminology does not appear to be significant. Tribunals use all three terms to focus the expropriation enquiry on the extent to which a measure alters an investor's entitlements under domestic law to use, enjoy or dispose of its investment in certain ways.

In this chapter I use the term 'property interest' in discussion of the *Pope & Talbot* approach to avoid confusion with the term 'vested legal right' as it relates to the doctrine of legitimate expectations under the FET standard. The meaning of 'property interest' in this Chapter is broader than the meaning of 'vested legal right' in Chapter 5. An investor's entitlement to use property in a certain way under prevailing regulatory arrangements would

[1086] *Fireman's Fund* (n 989) [176]; *Chemtura* (n 514) [249].

[1087] *Pope & Talbot, Interim Award* (n 615) [96].

[1088] ibid (n 615) [99].

[1089] *Sempra* (n 608) [284].

[1090] *Grand River* (n 653) [154].

qualify as a property interest; it would not amount to a vested legal right unless the investor held an *enforceable* right for general regulations to remain unchanged (for example, a right under a contract or licence). According to this understanding of property interest, an investor's ability to use an investment in a way that is permitted under prevailing domestic law is a property interest; an investor's ability to use an investment in a way that requires a permit under prevailing domestic law is a limited property interest circumscribed by the duration and terms of the permit; an investor's expectation or hope that it will be able to use an investment in a way that is not currently permitted under domestic law is not a property interest.

The Tribunal in *Sempra v Argentina* gave perhaps the most comprehensive articulation of the *Pope & Talbot* approach, equating indirect expropriation with the interference with an investor's ownership or control of an investment:

> Substantial deprivation results ... from depriving the investor of control over the investment, managing the day-to-day operations of the company, arresting and detaining company officials or employees, supervising the work of officials, interfering in administration, impeding the distribution of dividends, interfering in the appointment of officials or managers, or depriving the company of its property or control in whole or in part.[1091]

The Tribunal acknowledged that its list was not exhaustive but explained that indirect expropriation 'would still have to meet the standard of having as a result a substantial deprivation of rights.'[1092]

More recent decisions have been particularly important in clarifying the implications of a focus on the claimant's legal entitlements in cases concerning the expropriation of contracts. The dispute in *Bayindir v Pakistan* arose from a situation in which Pakistan had terminated a construction contract with Bayindir and expelled it from the country, citing its

[1091] *Sempra* (n 608) [284].

[1092] ibid.

poor contractual performance. The Tribunal held that 'if the expulsion was lawful under the Contract, then there would be no taking of or interference with Bayindir's rights.'[1093] The fact that the state's action was consistent with a 'reasonable interpretation of the Contract' was, according to the Tribunal's interpretation of indirect expropriation, sufficient to show that Bayindir's contractual rights had not been indirectly expropriated.[1094] The majority in a recent decision *Impregilo v Argentina* came to the same view.[1095]

In another contract case, *Biwater v Tanzania*, the Tribunal applied the *Pope & Talbot* approach, stressing the distinction between rights and value. It said: '[a] distinction must be drawn between (a) interference with rights and (b) economic loss. A substantial interference with rights may well occur without actually causing any economic damage'.[1096] The Tribunal found that Tanzania had effectively extinguished Biwater's rights in a water concession contract. It quantified the compensation owing for this expropriation at zero.[1097]

The *Grand River v US* Tribunal discussed the converse factual scenario, the situation in which serious economic loss is not accompanied by a substantial interference with property interests. The Tribunal observed that:

> ICISD tribunals have rejected expropriation claims involving significant diminution of the value of a claimant's property where the claimant nevertheless retained ownership and control.[1098]

It held that 'expropriation must involve the deprivation of all, or a very great measure, of a claimant's property interests.'[1099]

[1093] *Bayindir* (n 576) [458].

[1094] ibid [458]-[460]

[1095] *Impregilo v Argentine Republic* ICSID Case No ARB/07/17, Award, 21 June 2011 [272].

[1096] *Biwater* (n 485) [464].

[1097] ibid [519].

[1098] *Grand River* (n 653) [151].

The *Pope & Talbot* formula of 'substantial deprivation' of property interests has been cited and applied by a number of other decisions, including *Enron*, *Nykomb v Latvia* and *CMS v Argentina*.[1100] There are also occasional decisions within the effects structure that mix discussion of the effect a measure on a claimant's property interests with discussion of its effect on the value of the investment, such as *BG v Argentina* and *National Grid v Argentina*.[1101] Although these decisions do not fall neatly within the *Pope & Talbot* approach, they are consistent with it. Their examination of loss of economic value caused by goes to the assessment of whether the deprivation of property interests was substantial.[1102] These decisions do not appear to countenance the possibility that severe loss of economic value would be sufficient for a finding of indirect expropriation in the absence of interference with property interests.

6.4.2.2 Restatement of the Pope & Talbot *approach*

The *Pope & Talbot* Tribunal requires a substantial deprivation for a finding of expropriation. This approach looks to the deprivation of property interests; the catalogue of examples of regulatory expropriation provided by the *Pope & Talbot* Tribunal are all 'actions ousting the Investor from full ownership or control of the Investment.'[1103] The approach does not provide precise guidance as to when a given interference with an investor's entitlements to use, enjoy or dispose of an investment will amount to expropriation. Nevertheless, it is clear that qualitative judgements about the extent of interference in the context of the claimant's

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[1099] ibid [154].

[1100] *Enron* (n 584) [245]; *Nykomb* (n 1009) 33; *CMS* (n 584) [263].

[1101] *BG Group* (n 613) [266]; *National Grid* (n 608) [149].

[1102] *BG Group* (n 613) [270]-[271]; *National Grid* (n 608) [150]-[154].

[1103] *Pope & Talbot, Interim Award* (n 615) [100].

investment are more important than quantitative assessments of the loss suffered by the claimant.

6.4.3 The effect of *appropriation*: an alternative approach?

Newcombe argues that the competing strands of jurisprudence on indirect expropriation in international investment law can be reconciled by 'rereading' them as instances of the *appropriation* of property by the state or a third party.[1104] Only two arbitral decisions arguably support Newcombe's view: *Lauder v Czech Republic* and *Olguin v Paraguay*.[1105] The statements in both decisions were intimately tied to their contexts and did not purport to establish a general interpretative approach. In *Olguin*, the relevant passage justified the finding of fact that an omission of the government had not *caused* the alleged loss.[1106] In *Lauder*, the Tribunal accepted that indirect expropriation normally involved appropriation, but explicitly formulated its finding in terms of deprivation.[1107] Whatever the policy merits of a legal test based on appropriation, no established strand of jurisprudence in international investment law supports this approach.

6.4.4 Summary: the effects structure of enquiry

This section has identified two interpretations of indirect expropriation that turn exclusively on a measure's effects. The first is based on the *Metalclad* decision; it looks to whether a measure deprives the investor of the reasonably expected economic benefits of the investment. The second is based on the *Pope & Talbot* decision; it looks to whether a

[1104] Andrew Newcombe, 'The Boundaries of Regulatory Expropriation in International Law' (2005) 20 ICSID Review - FILJ 1, 7.

[1105] *Lauder* (n 606) [203]; *Olguin v Republic of Paraguay* ICSID Case No ARB/98/5, Award, 26 July 2001 [84].

[1106] *Olguin* (n 1105) [84].

[1107] *Lauder* (n 606) [200]-[201].

measure substantially deprives the investor of property interests in the investment, particularly rights of ownership and control.

6.5 The exception structure of enquiry

IITs rarely contain exception clauses to their expropriation provisions.[1108] If an exception for certain regulatory measures exists, it must be found within the meaning of 'indirect expropriation'. This section examines arbitral decisions that have held that measures with certain characteristics do not amount to compensable indirect expropriation. To be sure, such decisions still require that a measure have a sufficient effect on an investment for it to be potentially expropriatory. Decisions that recognise exceptions to indirect expropriation draw on a particular understanding of the doctrine of 'police powers' in customary international law, the view that:

> [A] state is not responsible for loss of property ... resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if it is not discriminatory.[1109]

This section identifies one interpretation of indirect expropriation within the exception structure of enquiry.

[1108] Two of only a handful of IITs that provide an exception to indirect expropriation are: the Common Market for Eastern and Southern Africa Common Investment Area Agreement (23 May 2007) art 20(8); and the ASEAN Comprehensive Investment Agreement (26 February 2009). Article 4 of Annex 2 the latter provides that:

> Non-discriminatory measures of a Member State that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an expropriation of the referred to in sub-paragraph 2(b) [indirect expropriation]

This is variation on Annex B of the 2004 US Model BIT (n 27); text to n 1175.

[1109] See, American Law Institute (n 1084) s 712 g.

6.5.1 The *Methanex* approach

The leading arbitral decision within the exception structure of enquiry is *Methanex v US*. Methanex was the world's largest producer of methanol, the chemical building block of the fuel additive MTBE.[1110] Methanex claimed that a Californian regulation that banned the sale and use of MTBE amounted to expropriation because it significantly deprived it of its 'customer base, market share and goodwill'.[1111] This regulation was motivated by the public health and environmental concerns relating to MTBE contamination of groundwater.[1112]

The Tribunal might have resolved the claim by considering whether customer base, market share and goodwill constitute investments; or whether a regulation that affects these economic interests can amount to an expropriation of a claimant's enterprise (which did, undoubtedly, constitute an investment). Instead, it dealt with the exception first, allowing it to avoid the question of whether the measure would otherwise have amounted to an expropriation. It held that:

> [A] non-discriminatory regulation for a public purpose, which is enacted in accordance with due process, and which affects, inter alios a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government... to refrain from such regulation.[1113]

This statement defines a categorical exception to indirect expropriation, an interpretation that went beyond the more qualified submissions of both the parties.[1114] In applying this legal test to the facts, the Tribunal concentrated on the criteria of non-discrimination, due process and

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[1110] *Methanex* (n 470) pt I [1].

[1111] ibid pt IV ch D [5].

[1112] ibid pt III ch A [1]-[12].

[1113] ibid pt IV ch D [7].

[1114] *Methanex v United States: Rejoinder of the Respondent* 23 April 2004 [194]; *Methanex v US: Reply of Claimant to Amended Statement of Defence* 19 February 2004 [207].

non-violation of commitments. Through a detailed enquiry into the history of the regulation, it found them all easily satisfied.[1115]

Another decision that applied an exception structure in the regulatory expropriation enquiry was *Saluka v Czech Republic*. Saluka was a major foreign shareholder in the Czech bank IPB. The Banking Act required all banks to maintain payment ability through a minimum 'liquidity cushion'. In 2000 the Czech Banking Regulator found that IPB had continuously failed to maintain payment ability and forced it into liquidation, as it was entitled to do under the Banking Act.[1116] Unlike *Methanex*, the *Saluka* decision began with a finding that the claimant had been deprived of its investment.[1117]

The Tribunal cited the *Third Restatement of the Foreign Relations Law of the United States* (*Third Restatement*) and *Methanex* to support the statement of customary international law that:

> [S]tates are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare.[1118]

The Tribunal confirmed that these characteristics of the regulation were not to be balanced against its effects; satisfaction of these criteria was sufficient to find that the measure did not amount to indirect expropriation.[1119]

Despite the differences in terminology, the legal tests in both *Methanex* and *Saluka* were remarkably similar. The *Saluka* Tribunal appears to have inferred low level

[1115] *Methanex* (n 470) pt IV ch D [8]-[15].

[1116] *Saluka* (n 165) [271]-[272].

[1117] ibid [267].

[1118] ibid [255].

[1119] ibid [275].

requirements of procedural and substantive justification of the measure from the concept of 'normal exercise'.[1120] On the facts, the measures were justified because both the final decision of the banking regulator and the process by which the decision was reached were reasonable.[1121] These two observations are consistent with the public purpose and due process requirements of *Methanex*.

In the 2010 decision in the consolidated claims of *Suez, InterAgua and Vivendi v Argentina* the claimants alleged that a series of measures culminating in the termination of their water concession with the Santa Fe provincial government amounted to indirect expropriation.[1122] The Tribunal held that 'an indirect expropriation requires a substantial deprivation of an investment.'[1123] To determine whether the state's termination of the contract fell afoul of this standard, it examined whether the state acted consistently with the framework of legal rights established by the contract.[1124] This much is consistent with the *Pope & Talbot* approach.

In addition to the threshold requirement that a measure constitute a substantial deprivation, the Tribunal recognised an exception to indirect expropriation for measures within a state's police powers, citing the *Third Restatement*, *Methanex* and *Saluka* as authority.[1125] The Tribunal then applied this exception in the review of Argentina's unilateral cancellation of the tariff indexation mechanism in public service contracts, including the claimant's concession contract. It concluded that deindexation was a general measure taken

[1120] ibid [265], [271].

[1121] ibid [272].

[1122] *Suez and Vivendi* (n 137) [135]; *Suez and InterAgua* (n 647) [124].

[1123] *Suez and Vivendi* (n 137) [145]; *Suez and InterAgua* (n 647) [134].

[1124] *Suez and Vivendi* (n 137) [151]-[155]; *Suez and InterAgua* (n 647) [141].

[1125] *Suez and Vivendi* (n 137) [139]; *Suez and InterAgua* (n 647) [128].

in the context of a severe crisis and therefore fell within the state's police powers; it also held that the measure did not, in any case, meet the threshold of substantial deprivation.[1126] Perhaps for this reason, the decision did not consider the significance of the *Methanex* Tribunal's condition that, to fall within the police power exception to indirect expropriation, a measure must not be contrary to 'specific commitments by the regulating government to refrain from such regulation.' [1127] Arguably, Argentina had made contractual commitments not to deindex tariffs.

In *Chemtura v Canada* the claimant alleged that the cancellation of its registration to sell lindane-containing pesticide, a product it produced and sold, constituted indirect expropriation.[1128] The Canadian Pest Management Regulatory Agency (PMRA) had imposed the ban due to concerns about the health risks of lindane-containing pesticides.[1129] The Tribunal began by noting differences between the *Metalclad* and *Pope & Talbot* decisions, so far as they relate to the effects required for a measure to constitute expropriation. It found no need to resolve the controversy, holding that the standard was, broadly, one of 'substantial deprivation' and that this standard required 'fact-sensitive' application.[1130] As the claimant remained in control of the company, and the company remained profitable the Tribunal found that there had been no substantial deprivation. The Tribunal added that, in any case, the measure would have fallen within the police powers exception to indirect expropriation:

> The PMRA took measures within its mandate, in a non-discriminatory manner, motivated by the increasing awareness of the dangers presented by lindane for human health and the environment. A measure adopted under

[1126] *Suez and Vivendi* (n 137) [140]; *Suez and InterAgua* (n 647) [129].

[1127] *Methanex* (n 470) pt IV ch D [7].

[1128] *Chemtura* (n 514) [251].

[1129] ibid [21]-[29].

[1130] ibid [249].

> such circumstances is a valid exercise of the State's police power and, as a result, does not constitute an expropriation.[1131]

6.5.1.1 Restatement of the Methanex *approach*

Methanex is the archetype of the exception structure of the indirect expropriation enquiry. The legal test stated in that decision is schematic and clear, and has been endorsed and applied in the more recent decisions such as *Suez*. A measure will not be classed as expropriatory if it meets the requirements of being:

1. a regulation;
2. that is non-discriminatory;
3. for a public purpose;
4. enacted in accordance with due process; and
5. made without specific commitments by the regulating government to refrain from such regulation.

The cases that adopt the exception structure of enquiry have not fully specified the extent of effect on an investment required for a measure to be classed as potentially expropriatory, although there appears to be a preference for the *Pope & Talbot* approach. Nor have these cases fully fleshed out the *Methanex* criteria for a noncompensable exercise of police powers. In particular, none of these decisions provides a comprehensive account of the range of public purposes capable of justifying a measure that would otherwise amount to indirect expropriation.[1132] Taken together, they suggest that public health, environmental protection, banking regulation and economic restructuring in a time of crisis are among the legitimate public purposes.

[1131] ibid [266].

[1132] Allen Weiner, 'Indirect Expropriations' (2003) 5 International Law FORUM du droit international 166, 171; *Saluka* (n 165) [262], [263].

6.6 The balancing structure of enquiry

This section examines arbitral decisions that consider both the effects and the characteristics of a measure in determining whether it constitutes indirect expropriation. Decisions that employ this structure of enquiry can be distinguished from those within the exception structure in that, within the balancing structure, a measure may have the indicia of legitimate noncompensable regulation, yet still constitute indirect expropriation on account of its severe effect on an investment. A number of academic writers support the view that determination of whether an indirect expropriation has occurred involves a 'case-by-case' approach in which both the effects and the characteristics of the measure are relevant.[1133] This section identifies two interpretative approaches within the balancing structure: the characterisation-as-balancing approach; and the proportionality approach. It also notes the potential for a third interpretative approach to emerge in the future, based on the interpretative annexes of new US and Canadian BITs.

6.6.1 The characterisation-as-balancing approach

The most common balancing approach applied by tribunals involves characterisation of the measure. The clearest statement of the characterisation-as-balancing approach is from *Feldman v Mexico*: 'the essential determination is whether the actions... constitute an expropriation or nationalization, or are valid governmental activity'.[1134] The language of characterisation is sometimes invoked by tribunals using effects or exception structures. [1135] Within the balancing structure, characterisation refers to a more specific method of reasoning. Characterisation-as-balancing treats a wide range of effects on the investor and characteristics

[1133] Katia Yannaca-Small, 'Indirect Expropriation and the Right to Regulate' in Katia Yannaca-Small (ed), *Arbitration Under International Investment Agreements* (Oxford University Press 2010) 476; McLachlan, Shore and Weiniger (n 635) 298; Salacuse (n 32) 317.

[1134] *Feldman* (n 984) [98].

[1135] *Biloune v Ghana* (1993) 95 ILR 183 [603]; *Saluka* (n 165) [264].

of the measure as potentially relevant. All these factors are weighed against each other and the tribunal then makes a fact-specific conclusion.

The brief decision of *SD Myers v Canada* laid out a basic framework for the characterisation approach. SD Myers challenged Canada's temporary export ban on polychlorinated biphenyl. The Tribunal determined that 'expropriation' should be interpreted consistently with 'the whole body of state practice, treaties and judicial interpretations of that term'.[1136] This approach contrasts with decisions applying both the effects and exception models, which tend to cite narrowly from the line of authority that supports their approach. In *SD Myers* the Tribunal positioned a measure's effect on the investment at the centre of characterisation, saying 'expropriations tend to involve the deprivation of ownership rights; regulations a lesser interference.'[1137] Beyond this initial assessment 'international law makes it appropriate to consider both the purpose and effect of governmental measures'.[1138] The decision did not refer to any 'purpose' elements as the facts fell short of establishing the effect necessary for expropriation.

In *Feldman,* the Tribunal balanced the effects of a measure against its characteristics in a more even way. The claimant operated a business which exported cigarettes. After a number of years of inconsistent statements, the Mexican authorities decided that Feldman was no longer entitled to the tax rebates he had previously received.[1139] Although the claimant alleged an 'agreement' with the authorities, the Tribunal found that the claimant had no right to the rebates under Mexican law. In formulating the legal standard, the Tribunal 'sought guidance' from both *Metalclad* and the *Third Restatement*. It recognised that

[1136] *SD Myers* (n 487) [280].

[1137] ibid [282].

[1138] ibid [281].

[1139] *Feldman* (n 984) [109].

regulations could amount to expropriation,[1140] but held that expropriation should be distinguished from noncompensable regulation 'in light of all the circumstances'.[1141] The Tribunal identified four relevant factors in the case in question.[1142] Two concerned the characteristics of the measure: the *general* character of the tax; and the fact that the regime had a 'rational public purpose'.[1143] The other two factors concerned the effects of the measure: the fact that the claimant was not deprived of any legal right; and the fact that the investor retained control of the investment.[1144] All four factors pointed against indirect expropriation. The Tribunal's characterisation-as-balancing approach was most explicit in its conclusion: 'while none of these factors alone is necessarily conclusive, in the Tribunal's view, taken together they tip the expropriation/regulation balance away from a finding of expropriation'. *Feldman* was followed in *Generation Ukraine v Ukraine*.[1145]

The most comprehensive expression of the characterisation-as-balancing approach was made in *Fireman's Fund v Mexico*. The Tribunal said that:

> To distinguish between a compensable expropriation and a noncompensable regulation by a host state, the following factors (usually in combination) may be taken into account: whether the measure is within the recognized police powers of the host State; the (public) purpose and effect of the measure; whether the measure is discriminatory; the proportionality between the means employed and the aim sought to be realized; the bona fide nature of the measure.[1146]

[1140] ibid [110].

[1141] ibid [106], [102].

[1142] ibid [111].

[1143] ibid [112]-[116], [136]-[137].

[1144] ibid [111], [117]-[134].

[1145] *Generation Ukraine* (n 993) [20.34].

[1146] *Fireman's Fund* (n 989) [176].

The Tribunal added that the effect on an investor's 'investment backed expectations' could also be considered.[1147] The concept of investment backed expectations is derived from jurisprudence on the US 5th amendment and is incorporated in the interpretative annexes of recent US and Canadian BITs.[1148] A lengthy footnote in the *Fireman's Fund* decision justified assessment of 'investment backed expectations' on the grounds that:

> [I]nterference with the investor's enterprise [should be] considered in light of the investor's chosen business model, the nature of the enterprise, the regulatory regime in place at the time of investment, and associated expectations ...[1149]

This much is consistent with *Pope & Talbot* approach's focus on the protection of property interests, which would include the protection of expectations that are based in the legal entitlements of the investor under prevailing regulatory arrangements.

The application of the law to the facts in *Fireman's Fund* did not clarify the balancing or weighing process to be applied in characterisation. However, it did clarify the structure of the enquiry by requiring an initial threshold of effect, before moving to the balancing process. Fireman's Fund challenged five separate regulatory measures in the recapitalization of a Mexican bank in which it was a major investor. The measure which came closest to expropriation was the repurchase of debentures by the state, which discriminated between peso-denominated debentures, held by Mexican nationals, and dollar-denominated debentures, held by Fireman's Fund.[1150] The Tribunal dismissed the indirect expropriation claim, saying 'a discriminatory lack of effort by a host State to rescue an investment that has

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[1147] ibid.

[1148] Text to n 1172.

[1149] Coe and Rubins (n 472), cited in *Fireman's Fund* (n 989) [176].

[1150] *Fireman's Fund* (n 989) [202].

become virtually worthless, is not a taking of that investment.'[1151] Fireman's Fund was cited and applied in *Corn Products v Mexico* and followed, without citation, by *Arthur Daniel Midlands v Mexico*.[1152]

6.6.1.1 Restatement of the characterisation-as-balancing approach

Fireman's Fund embodies the current state of the characterisation-as-balancing approach. The approach can be restated as:

1. A minimum threshold of effect on the investor's property interests – 'substantially complete deprivation of the economic use and enjoyment of rights to the property' – is required for expropriation. [1153] This much is consistent with the *Pope & Talbot* approach.
2. Beyond this threshold, the characteristics of the regulation – whether the measure is discriminatory, of general application, proportionate, and applied in good faith – are all potentially relevant in the indirect expropriation enquiry, as are the severity of its effects.
3. Tribunals consider all the relevant elements on the specific facts and then characterise the measure as either expropriation or legitimate noncompensable government action.

6.6.2 *Tecmed v Mexico*: the proportionality approach

Tecmed v Mexico concerned a hazardous waste facility. The investor held a licence to operate the facility for one year, which was renewable annually. In response to community opposition to the facility, the authorities and the investor agreed that the facility should be moved to a

[1151] ibid [207].

[1152] *Corn Products International v Mexico* ICSID Case No ARB(AF)/04/01, Decision on Responsibility, 15 January 2008 [87]; *Archer Daniel Midlands v Mexico* ICSID Case No ARB(AF)/04/05, Award, 21 November 2007 [250].

[1153] *Fireman's Fund* (n 989) [176].

different location. Within months of this agreement, the authorities declined to renew the annual licence that allowed the facility to operate at its original site.[1154] The tribunal did not determine whether, prior to this decision, Tecmed had a right to continued operation of the facility in its existing location under Mexican law; it was enough that the investor had a reasonable expectation of continued operation.[1155] On this basis, the Tribunal found that the investor had been 'radically deprived of the economical use and enjoyment of its investment'.[1156]

While agreeing that a measure's severe effect on the economic value of an investment was not sufficient to support a finding of indirect expropriation, the *Tecmed* Tribunal rejected a general exception to indirect expropriation for regulatory measures 'beneficial to society as a whole'.[1157] Instead, it held that 'there must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized' for a measure to fall outside the class of compensable indirect expropriation.[1158] As authority for this standard, the Tribunal cited four leading decisions of the European Court of Human Rights (ECHR).[1159] Applying its formulation to the facts the Tribunal found that the denial of permit was not proportionate as environmental or health issues relating to the operation of the site could have been addressed through financial penalties on the investor.[1160]

[1154] *Tecmed* (n 484) [160].

[1155] ibid [149]-[150].

[1156] ibid [115].

[1157] ibid [119]-[122].

[1158] ibid [122].

[1159] ibid [116], [122].

[1160] ibid [148].

At this point, it is important to note differences between ECHR jurisprudence and the proportionality test, as formulated by the *Tecmed* Tribunal. Unlike the expropriation provisions of IITs, Article 1 of Protocol 1 to the European Convention of Human Rights contains three distinct rules: a general rule; a rule covering deprivation of property; and a rule dealing with control of use of property.[1161] While means-ends proportionality is required by all three rules,[1162] the enquiry is framed by the unique tripartite structure. This framing has significant consequences – for example, a measure that falls within the control of use rule is rarely found to be a disproportionate interference with the claimant's right to property.[1163] Furthermore, in the ECHR's enquiry under each of the three rules, the amount of compensation is weighed together with the degree of interference with the property and the public interest pursued by a measure to determine if the applicant's right to property has been breached.[1164] This contrasts with the expropriation provision of IITs. Under IITs a tribunal must first determine whether an indirect expropriation has occurred and, only then, consider whether the compensation required by the treaty was paid.[1165]

Azurix v Argentina concerned the alleged expropriation of a water concession contract. In discussing the effects on an investment required for a measure to amount to expropriation the Tribunal agreed with *Tecmed* that indirect expropriation need not require an interference with the investor's legal entitlements; and that a state could indirectly expropriate an investment by breaching prior unilateral statements in a way that deprives the

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[1161] *Sporrong and Lönnroth v Sweden* (1982) 5 EHRR 85 [61].

[1162] ibid [69]; *James* [50]; *Mellacher v Austria* (1990) 12 EHRR 391 [48].

[1163] *Mellacher* (n 1162) [45]; Yutaka Arai-Takahashi, *The margin of appreciation doctrine and the principle of proportionality* (Intersentia Uitgevers 2002) 148.

[1164] Arjen van Rijn, 'Right to the Peaceful Enjoyment of One's Possessions' in Pieter van Dijk and others (eds), *Theory and Practice of the European Convention on Human Rights* (4th edn, Intersentia 2006) 881.

[1165] Text to n 976.

investor of the 'reasonably-to-be-expected economic benefit of its investment.'[1166] The Tribunal also accepted that a finding of expropriation would require a further judgement that the interference with the value of the investment was not proportionate. 'This proportionality will not be found if the person concerned bears "an individual and excessive burden".'[1167] On the facts, the Tribunal found that disputes over tariffs and payment of bills under the concession did not have a sufficient effect to amount to expropriation.[1168]

The Tribunal in *LG&E v Argentina* relied on the same understanding of indirect expropriation. It cited *Tecmed* as authority for the proposition that:

> [I]t can generally be said that the State has the right to adopt measures having a social or general welfare purpose. In such a case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed.[1169]

The Tribunal did not to consider whether the measures in question were proportionate as they did lacked sufficient effect on the investment to amount to indirect expropriation – they had not caused 'severe deprivation of LG&E's rights with regards to its investment or almost complete deprivation of the value of LG&E's investment.'[1170]

6.6.2.1 Restatement of the Tecmed *approach*

The *Tecmed* approach is a clearly defined interpretation of indirect expropriation within the balancing structure. Both the more recent cases that adopt this approach to indirect expropriation cite the *Tecmed* decision as authority for their conclusions. While the *Tecmed* approach draws on the jurisprudence of the ECHR, it does not accurately reflect the contours

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[1166] *Azurix* (n 610) [316].

[1167] ibid [311].

[1168] ibid [322].

[1169] *LG&E Energy* (n 679) [195].

[1170] ibid [200].

of ECHR jurisprudence. Under the *Tecmed* approach a finding of indirect expropriation requires:

1. A 'radical deprivation' or 'near complete deprivation' of the value of the investment. Like the *Metalclad* approach, a measure that affects the reasonably-expected economic value of the investment can amount to indirect expropriation, even if it does not interfere with property interests in the investment. However, the *Tecmed* approach seems to require a more severe decrease in economic value than the *Metalclad* approach.
2. A measure that exceeds this threshold of impact on economic value will only amount to an expropriation if there is a lack of proportionality between the loss to the claimant and the public interest pursued by the measure.

6.6.3 The potential for a new approach based on the US and Canadian model BITs

Unlike most IITs, the 2004 Canadian and US Model BITs provide some guidance as to the criteria by which indirect expropriation should be identified. This guidance is contained in annexes to the model treaties, which document 'understandings' on the interpretation of expropriation. Recent US and Canadian BITs incorporate these model provisions.[1171] The US Model states that:

> The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by case, fact-based enquiry that considers, among other factors:
>
> (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
>
> (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

[1171] eg US-Uruguay BIT (4 November 2005) annex B; Canada-Peru BIT (14 November 2006) annex B 13(1).

(iii) the character of the government action.[1172]

The Canadian Model BIT articulates the same three factors, and is worded almost identically.[1173] Both annexes are 'integral parts' of their respective treaties.[1174] They require indirect expropriation to be identified within a balancing structure; criteria i) and ii) refer to the effect of a measure, while criterion iii) refers to its characteristics.

Both model BITs include a further paragraph, clarifying that regulatory measures do not normally amount to indirect expropriation. The US Model reads:

> Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.'[1175]

The Canadian Model identifies the situation 'when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith' as an example of the 'rare circumstances' that could amount to indirect expropriation.[1176]

To this point, no dispute under an IIT containing one of these annexes has come before an arbitral tribunal. However, two recent decisions under IITs that do not contain these annexes have referred to them, on the grounds that they restate customary international law on the concept of indirect expropriation.[1177] In *Continental Casualty v Argentina*, the Tribunal simply identified Annex B of the US Model BIT as one of a number of attempts to

[1172] US Model BIT (n 27) annex B 4(a).

[1173] Canada Model BIT (n 27) annex B 13(1).

[1174] ibid art 52(1); US Model BIT (n 27) art 35.

[1175] US Model BIT (n 27) annex B 4(b).

[1176] Canada Model BIT (n 27) annex B 13(1) c).

[1177] US Model BIT (n 27) annex B 1; *Continental Casualty* (n 738) [276].

clarify the meaning of indirect expropriation. It did not attempt to interpret or apply the annex. *Glamis Gold v US* cited Annex B of the US Model BIT as authority for the proposition that an indirect expropriation requires a threshold of economic impact on the investment.[1178] It did not explore the interplay of this factor with the other factors listed by the Model BIT. As such, no arbitral tribunal has yet explored the full implications of the annexes for the concept of indirect expropriation.

It is not possible to predict how tribunals would interpret these annexes, if they were required to apply them. As such, it is not possible to determine the level of protection they provide. Opinions differ as to whether the legal enquiry described in the annexes is consistent with existing arbitral interpretations of indirect expropriation. Yannaca-Small argues that the annexes are similar to the criteria tribunals use to identify indirect expropriation in existing arbitral jurisprudence.[1179] (Her reading of existing jurisprudence is broadly consistent with what I describe as the characterisation-as-balancing approach.) On the other hand, Paparinskis contrasts the annexes to both the *Tecmed* and *Methanex* approaches. In his view, the annexes imply that regulatory measures enacted for a public purpose would not amount to indirect expropriation, even if they were not applied with due process.[1180] A further possibility is that the annexes might encourage tribunals to draw directly on US constitutional jurisprudence. The three criteria articulated in the annexes are the *Penn Central* factors from the Supreme Court's regulatory expropriation jurisprudence.[1181]

[1178] *Glamis Gold* (n 514) [356].

[1179] Yannaca-Small, 'Indirect Expropriation and the Right to Regulate' (n 1133) 460.

[1180] Paparinskis (n 1035) 321.

[1181] *Kaiser Aetna v United States* 444 US 164 (1979) 175; Andrew Newcombe, 'Canada's New Model Foreign Protection Agreement' (2004) 6 <http://ita.law.uvic.ca/documents/CanadianFIPA.pdf> accessed 7 May 2008; Matthew Porterfield, 'International Expropriation Rules and Federalism' (2004) 23 Stanford Environmental Law Journal 3, 43.

In summary, no new, coherent interpretative approach to the concept of indirect expropriation has emerged in arbitral decisions as a result of the interpretative annexes that are included in recent US and Canadian BITs. This thesis does not compare the option of adopting the US or Canadian interpretative annexes to the option of adopting the other approaches sketched in this section because the interpretative annexes do not define a particular level of protection with sufficient specificity to be the subject of evaluation.

6.7 Conclusion

This chapter examined the way in which arbitral tribunals interpret the concept of indirect expropriation under IITs. Section 6.2 reviewed the expropriation provisions of IITs and argued that arbitral tribunals treat differently worded expropriation provisions as if they all embody a common concept of indirect expropriation. Section 6.3 proposed a basic taxonomy of the structures of enquiry that tribunals use to distinguish indirect expropriation from legitimate, non-compensable government measures: those that look exclusively to the effects of the measure on the protected investment (the effects structure); those that define expropriation by its effects, subject to exceptions for measures with certain characteristics (the exception structure); and those that balance the effects on the investment and the characteristics of the impugned measure in determining whether an expropriation has occurred (the balancing structure).

Section 6.4 examined decisions within the effects structure. It identified two alternative interpretations of indirect expropriation within this structure: one, originating from *Metalclad*, that looks to the effect of the measure on the economic value of the investment; the other, originating from *Pope & Talbot*, that looks to the effect of the measure on the investor's property interests in the investment. Section 6.5 considered decisions within the exception structure. It identified one interpretation within this structure, based on the

exception for legitimate regulatory conduct articulated in *Methanex*. Section 6.6 explored decisions within the balancing structure. It identified two interpretations within this structure: one involving a broad characterisation of a measure as either expropriatory or noncompensable; the other involving proportionality review, as articulated in *Tecmed*. While many of these models have their roots in earlier decisions, they have been developed, clarified and endorsed in subsequent decisions. Each interpretation is sketched as a model level of protection, which might be explicitly adopted in future IITs. Chapter 7 applies the normative framework developed in Chapter 4 to evaluate the normative merits of adopting each of these five levels of protection.

Chapter 7 Application of the Normative Framework and Conclusion

7.1 Introduction

This chapter answers the research question defined in Chapter 1: of the differing levels of investment protection implied by different interpretations of the FET and indirect expropriation provisions of IITs, which, if adopted, would be most desirable? It applies the normative framework developed in Chapter 4 to evaluate the differing levels of protection implied by different interpretations of each element of the FET standard, as identified in Chapter 5, and different interpretations of indirect expropriation, as identified in Chapter 6. This analysis, and the conclusions that are derived from it, constitute the principal original contribution of this thesis. These conclusions are a contribution to normative debates about IIT protections and to the development of public policy relating to the drafting and amendment of IITs. This chapter does not attempt to resolve doctrinal debate about the 'correct' interpretation of IIT protections, nor does it address the related question of whether arbitrators should consider the normative merits of alternative interpretations when tasked with interpreting and applying IIT protections in a given dispute. These are important questions, but questions that lie beyond the scope of this thesis.

This chapter comprises seven substantive sections. Section 7.2 briefly reintroduces the normative framework and explains the mechanics of its application in Sections. Sections 7.3, 7.4 and 7.5 apply the normative framework to evaluate differing levels of protection implied by different interpretations of each element of the FET standard. Section 7.6 applies the normative framework to evaluate differing levels of protection implied by different interpretations of indirect expropriation. Section 7.7 explores the implications of the conclusions for states in the drafting and amendment of IITs. Section 7.8 outlines some more general conclusions that emerge from the analysis that are relevant to existing normative

debate. Section 7.9 reflects on the normative framework in light of the experience of its application. This section assesses the strengths and limitations of the framework as well as its role in ongoing research and debate about IITs. These reflections conclude the thesis.

7.2 The normative framework: a brief recapitulation

Consequential evaluation, the methodology used in this thesis and presented in Chapter 3, is based on the premise that prospective evaluation of alternative legal rules should be based on an assessment of their likely consequences, as evaluated according to specified normative criteria. The normative framework developed in Chapter 4 proposes that the likely consequences of adopting a given level of IIT protection can be divided into effects on: efficiency; the distribution of economic costs and benefits; flows of FDI into host states; the realisation of human rights and environmental conservation in host states; and respect for the rule of law in host states. Chapter 4 drew a number of inferences relating to the likely consequences of various levels of IIT protections, which were stated in the form of propositions. It also articulated the normative criteria by which these consequences should be evaluated. Sections 7.3 to 7.6 of this chapter rely on these inferences, and the analysis underpinning them, to predict and evaluate the likely consequences of adopting each level of protection. If any of the levels of protection considered in this thesis were actually adopted by states, it would be important to consider the extent to which their impact was consistent with these predictions derived from Chapter 4.

This thesis is concerned with the *relative* desirability of alternative levels of protection and the methodology of consequential evaluation involves comparison of specific, concrete alternatives. For both reasons, the normative evaluation in Sections 7.3 to 7.6 is structured so as to focus on the points of difference between the various options – points of similarity being equally (un)desirable in each of the compared alternatives. In order to avoid

the assessment of differences between levels of protection becoming unwieldy, Sections 7.3 to 7.6 are organised as a series of paired comparisons – and, in one case, a three-way comparison – between levels of protection. This simplifies the application of the normative framework, in that it allows more precise focus on particular points of difference and the consequences that are likely to flow from these differences.

7.3 Which of the four levels of protection of foreign investors' legitimate expectations is the most desirable?

Chapter 5 placed a set of parameters on its analysis of decisions interpreting the FET standard. The relevant decisions under the FET standard can be divided into those dealing with three elements of the standard, each of which operates as a quasi-independent liability rule. These three elements are: the protection of investors' legitimate expectations; procedural review of government conduct; and substantive review of government conduct. Chapter 5 then identified a number of alternative interpretations of each of these elements of the FET standard in the reasoning of arbitral awards.

This section applies the normative framework to evaluate the four distinct levels of protection of investors' legitimate expectations implied by different interpretations of the FET standard and identified in Chapter 5:

i) The legal rights approach, in which legitimate expectations can only be based on legal rights vested in the investor.

ii) The strict conduct approach, in which legitimate expectations can be based on clear and specific unilateral statements made by the host state; or on general regulations in force at the time the investment was made, if the state has indicated that the regulations would not be changed.

iii) The permissive conduct approach, in which legitimate expectations can be based on unilateral statements made by the host state that need not be clear and specific to the investor; or on general regulations in force at the time the investment was made.

iv) The business plan approach, in which legitimate expectations can be based on an investor's business plans, if the host state knew of those plans.

This section infers and evaluates the likely consequences of each approach if it were adopted in future IITs. It begins by comparing the likely consequences of the business plan approach to the permissive conduct approach. It then compares the likely consequences of the permissive conduct approach to the strict conduct approach and, finally, the likely consequences of the strict conduct approach to the legal rights approach.

7.3.1 The business plan approach vs the permissive conduct approach

The essential difference between the business plan approach and the permissive conduct approach is that the former allows legitimate expectations to be derived solely from the business plans of a foreign investor. Therefore, normative evaluation of the two approaches turns on an examination of the likely consequences of extending a state's liability to actions that interfere with an investor's business plans, when such interference does not breach the investor's legal rights, nor breach unilateral assurances made by the host state, nor alter the regulatory regime that existed at the time of the investment.

7.3.1.1 Efficiency

One foundational causal inference articulated in Chapter 4 is that legal rules that place some investors in a better legal position than other investors are likely to reduce efficiency.[1182] According to neo-classical economic theory, markets' ability to allocate capital efficiently

[1182] Text to n 289.

depends on competitive equality among investors. This effect concerns relative levels of legal protection. On this basis, the business plan approach is likely to lead to less efficient organisation of production than the permissive conduct approach. A state's additional liability under the business plan approach does not turn on an examination of whether equivalent protections are provided to other investors. Rather, this approach would protect foreign investors' business plans, notwithstanding the fact that other investors were not entitled to equivalent protection under the domestic law of the host state.

Economic theory also suggests that investors will make more efficient investment decisions if they are entitled to compensation for loss caused by inefficient government conduct but not for loss caused by efficient conduct.[1183] This effect concerns absolute levels of legal protection. Moreover, as a number of legal substitutes are available to foreign investors to protect them from inefficient government measures (internationalised contracts, for example), under-protection of foreign investment is likely to cause less efficiency loss than over-protection. The latter form of inefficiency is commonly labelled 'moral hazard'.

Under a legal rule based on the business plan approach, the determination of liability would turn on an examination of the investor's business plans, not on an examination of whether the conduct that breached the investor's expectations was efficiency-improving. The latter would require an assessment of the aggregate economic costs and benefits of the conduct, regardless of whether they accrued to the state, the investor or other actors. Because the business plan approach does not depend on an overall assessment of a measure, it is highly unlikely that there would be any *de facto* correlation between a state's additional liability under the business plan approach and inefficient government conduct. On the contrary, an entitlement to compensation for interference with business plans is precisely the

[1183] Text to n 311.

sort of liability rule that is likely to discourage investors from internalising the risk to their business plans posed by future, efficiency-improving government conduct. The business plan approach is likely to be substantially less efficient than the permissive conduct approach on account of engendering moral hazard.

7.3.1.2 Distributive consequences

The previous section argued that preferring the business plan approach to the permissive conduct approach is likely to create net economic costs. Given that it establishes a broader basis of state liability than the permissive conduct approach and is unlikely to create net economic benefits, the benefits to foreign investors of adopting this approach are likely to entail corresponding costs in the territory of the host state. In democratic states this pattern of costs and benefits is likely to be regressive on egalitarian grounds.[1184] Moreover, the benefit to investors cannot be justified by libertarian theory, as the *additional* requirement to compensate for interference with investors' business plans is not linked to interference with investors' property rights.[1185] The benefits to investors at the expense of other actors cannot be justified by political process theory, as they do not flow from situations in which a tribunal has judged that the investor was arbitrarily singled out to bear a loss.[1186]

7.3.1.3 FDI flows

Existing evidence suggests that differences in the level of protection provided by IITs are unlikely to affect FDI flows.[1187] Moreover, neither of the two theories that speak to the relationship between IITs and FDI suggests that holding a state liable for interference with investors' business plans will increase FDI. As liability for disruption of an investor's

[1184] Text at n 381 and n 376.

[1185] Text to n 365.

[1186] Text at n 412.

[1187] Text at n 436.

business plans does not concern the protection of agreements struck with the host state, commitment theory does not offer any reason to think that it will increase FDI.[1188] Moreover, liability for disruption of an investor's business plans does not follow from an inquiry into the characteristics of a host state's legal regime, nor whether the state has acted legally or in accordance with principles of natural justice. As such, a state's additional liability under the business plan approach is unlikely to lead to greater FDI via the causal mechanism proposed by signalling theory.[1189]

7.3.1.4 Respect for the rule of law

The primary mechanism by which IIT protections might affect the degree of respect for the rule of law in host states is through internalisation of these protections by decision-makers and law-makers. Assuming that IIT protections are internalised to some extent, the key issue is whether a state's additional liability under the business plan approach is linked to failure to respect the rule of law.[1190] It is not. The Razian conception of the rule of law does not place substantive constraints on states' ability to enact laws that cause loss to individuals, regardless of whether the state knew of the potential for its action to cause such loss.

7.3.1.5 Realisation of human rights and environmental conservation

Empirical evidence concerning the effect of IIT protections on the realisation of human rights and environmental conservation is limited. Both theory and evidence, to the extent it exists, suggest that states are less likely to maintain measures that give rise to liability under an IIT.[1191] This implies that the larger the set of measures effective in realising human rights and conserving the environment for which a state would be liable under a given level of

[1188] Text at n 459.

[1189] Text following n 458.

[1190] Text following n 564.

[1191] Text to n 493.

protection, the greater the number of human rights and environmental measures that a state will abandon as a result of investor challenge. This translates to lesser realisation of these norms in practice. The business plan approach makes a state liable for a larger set of measures than the permissive conduct approach. Furthermore, the scope of a state's additional liability turns on the impact of conduct on the investor's interests, without reference to whether the measure is effective in realising human rights or environmental conservation. This is likely to lead to greater regulatory chill of environmental and human rights measures.

Theory also suggests that levels of protection which reduce a state's uncertainty about the extent of its liability tend to reduce the chilling of measures that would have been permissible under the level of protection in question.[1192] Because it is difficult for a state to stay abreast of every foreign investor's business plans (and the potential impact of any contemplated conduct on any of these plans), the business plan approach entails a high degree of uncertainty about the extent of a state's prospective liability. This additional uncertainty is a further reason why the business plan approach is likely to increase regulatory chill and diminish the realisation of human rights and environmental conservation.

7.3.1.6 Overall evaluation

There are no coherent normative arguments for preferring the business plan approach to the permissive conduct approach. Moreover, there are several reasons to think that the business plan approach is less normatively desirable. It is highly likely that it will reduce economic efficiency by engendering moral hazard and that it will increase regulatory chill of human rights and environmental measures. In addition, it is likely to result in a pattern of costs and benefits that cannot be justified by any theory of distributive justice.

[1192] Text following n 404.

7.3.2 The permissive conduct approach vs the strict conduct approach

Under both the permissive conduct and the strict conduct approaches to the doctrine of legitimate expectations, an expectation may be based either on a unilateral statement of the host state or on the regulatory framework that existed at the time the investment was made. The differences between the two approaches are that, under the permissive conduct approach:

- Expectations need not be based on a clear statement of the state's position; the risk of ambiguity in unilateral statements made by the authority must be borne by the state.
- In the assessment of whether a given expectation is legitimate, the perspective of the investor weighs more heavily in the balance than countervailing factors such as the political, social and cultural conditions in the host state.
- There is no strict requirement of reliance on an expectation based on a unilateral statement in the making of an investment.
- Change in general regulations that were basic to the legal regime that governed the investment, are sufficient to engender legitimate expectations without further supportive statements that the regulations would not be changed.

Under the strict approach the converse of each proposition is true.

7.3.2.1 Efficiency

The broader scope of state liability for change to the regulatory framework under the permissive conduct approach is likely to increase moral hazard.[1193] Under the permissive conduct approach, the assessment of whether a state is liable for regulatory change is investor-centric: a question of whether the changed regulation was 'basic' to the investment decision, not whether the change itself was inefficient on an economy-wide assessment. Similarly, liability for breach of unilateral statements arises independently of whether it

[1193] Text to n 314.

would be efficient for a state to reverse its previously stated position. Economy-wide judgements – for example, whether the expectation was reasonable given the political and economic situation in the host state – weigh less heavily in the determination of whether an expectation was legitimate than under the strict conduct approach. As such, the permissive approach is less likely to encourage investors to assess adequately the risk to their projects posed by efficient changes in regulation. Moreover, the additional protection provided by the permissive conduct approach is not concerned with establishing competitive equality between investors. It is, therefore, likely to be associated with greater inefficiency, due to discriminatory over-protection of foreign investors.

7.3.2.2 Distributive consequences

The previous section argued that preferring the permissive conduct approach to the strict conduct approach is likely to entail net economic costs. Given that the broader protection of the permissive conduct approach is likely to benefit foreign investors, these costs would be borne by actors within the host state. This pattern of costs and benefits is likely to be regressive on egalitarian grounds in states that are broadly democratic. Moreover, the benefit to foreign investors under the permissive approach cannot be justified by political process theory as liability is not contingent on the exclusion of a foreign investor from the decision-making process that leads to a breach of expectations, nor on the arbitrary 'singling-out' of a foreign investor from among similarly situated investors.[1194]

Evaluation of the additional distributive transfers associated with the permissive conduct approach according to libertarian theory is more difficult. Libertarianism cannot justify the broader protection of investors from losses caused by breach of unilateral representations. On the other hand, libertarianism demands compensation for changes to the

[1194] Text at n 412.

investor's legal entitlements to use, enjoy and dispose of property. This is consistent with the protection provided to expectations based on the regulatory framework at the time the investment was made under the permissive conduct approach.

7.3.2.3 Realisation of human rights and environmental conservation

Under both the permissive and the strict approach, liability stems from changes to regulations and departures from previously stated policies, which creates a risk that new measures that are effective in realising human rights and environmental conservation will be chilled. Under the permissive conduct approach the scope of liability is broader and liability turns primarily on the impact of conduct on the investor's interests, rather than broader assessments of whether the measure is effective in realising human rights or environmental conservation. For both reasons it is likely to cause greater regulatory chill.

7.3.2.4 FDI flows

There is no reason to think that the permissive conduct approach would stimulate greater flows of FDI than the strict conduct approach. Commitment theory suggests that FDI increases if IITs allow investors to enforce bargains made with the host state. An ambiguous unilateral statement is clearly not akin to a term of a negotiated bargain, nor does the fact that a given regulatory framework was in place at the time an investment was made constitute, of itself, an agreement to maintain the framework. Thus, commitment theory does not justify the permissive conduct approach, in which the risk of liability for the investor's reliance on ambiguous unilateral statements lies with the state.

7.3.2.5 Respect for the rule of law

Even assuming host states do internalise IIT protections to some extent, it is unlikely that the permissive conduct approach would lead to improvements in respect for the rule of law. Under the permissive conduct approach, liability does not turn on whether a state's change in

position complies with the rule of law. It does not depend, for example, on whether the conduct is lawful under domestic law, whether the change is prospective, or whether the state's new position is open and clear. A state's liability for breach of unilateral statement does not depend on whether an agency's discretion under law to take a new position was 'guided by open, clear and stable general rules.'[1195] Such criteria of liability might arguably encourage respect for the rule of law in host states, but they find no place in the permissive conduct approach.

The Razian conception of the rule of law does require that laws be relatively stable, so that people can be guided by their knowledge of the content of the law.[1196] This principle provides some normative justification for the permissive conduct approach. However, liability for change to the regulatory framework under the permissive conduct approach turns on analysis of whether the change in question is to the substantive detriment of an investor, not an analysis of whether changes were repeated or erratic. Thus, while the permissive conduct approach may encourage greater stability in the law, this effect would be an indirect and limited consequence of discouraging particular *substantive* legal changes.

7.3.2.6 Overall Evaluation

The only justifications for the permissive conduct approach are the partial justification provided by libertarian theory and the limited justification based on the principle of stability – one sub-principle within the Razian conception of the rule of law. On the other hand, there are good reasons to believe that the strict conduct approach would lead to net economic benefits, distributional effects that are more consistent with political process theory, and lesser interference with the realisation of human rights and environmental conservation than

[1195] Raz (n 113) 200; see, *Thunderbird*, *Separate Opinion* (n 632) [88].

[1196] Raz (n 113) 199.

the permissive conduct approach. These are sufficient grounds for a preference for the strict conduct approach.

7.3.3 The strict conduct approach vs the legal rights approach

The essential distinction between the strict conduct and the legal rights approaches is whether a protected expectation can be based on a specific and clear unilateral statement made by the host state. Some such expectations fall within the scope of the strict conduct approach; none are protected under the legal rights approach. (While the strict conduct approach also purports to protect expectations based on the regulatory framework in force at the time of investment, it seems that such expectations would only be protected in the presence of supportive unilateral statements.) Normative evaluation should, therefore, focus on this essential difference. This difference aside, the two approaches are doctrinally similar. Both agree that only reasonable expectations are protected by the doctrine; that the determination of whether an expectation is reasonable must be made in light of the political, socio-economic, cultural and historical conditions in the host state, as well as the host state's prerogative to alter regulations; and that to recover for breach of a legitimate expectation an investor must have relied on the expectation in making the investment.

7.3.3.1 Efficiency

The comparison of the two approaches' likely consequences for economic efficiency raises complex issues. A state's liability does not, under either approach, turn on a comparison of the foreign investor's treatment with the treatment of domestic investors. Greater legal protection of the expectations of foreign investors than is available to domestic investors disturbs competitive equality between investors. It is likely that the strict conduct approach goes beyond the protections that domestic law provide to investors from departure from

unilateral assurances, at least in some states.[1197] On this basis, the strict conduct approach is likely to be less efficient than the legal rights approach.

There is a further question of the absolute level of protection provided by each approach – particularly its effect on the efficiency of foreign investors' decisions. Liability rules that compensate investors for loss caused by new, inefficient regulations but not for loss caused by efficient regulations are likely to promote efficient investment decisions. Liability does not turn on an explicit examination of whether a state's conduct is efficient under either the strict conduct or the legal rights approach. However, under both approaches, tribunals have developed principles that govern the determination of whether an expectation is legitimate. The assessment of whether expectations are reasonable in all the circumstances may involve the tribunals in limited, *de facto* review of the economic costs and benefits of the government's change of position – the factors which determine the efficiency of the government's action.

A key issue is how closely the contours of a state's additional liability under the strict conduct approach correspond to the distinction between efficient and inefficient state conduct. Notwithstanding their broad review of whether an expectation is reasonable, decisions within the strict conduct approach do not attempt to come to even a rough estimation of the aggregate costs and benefits of government's conduct.[1198] Liability depends primarily on an examination of the circumstances in which the expectation formed; not analysis of the conduct that allegedly breached the expectation, or its economic

[1197] Irmgard Marboe, 'State Responsibility and Comparative State Liability for Administrative and Legislative Harm to Economic Interests' in Stephan Schill (ed), *International Investment Law and Comparative Public Law* (Oxford University Press 2010) 409; Hector Mairal, 'Legitimate Expectations and Informal Administrative Representations' in Stephan Schill (ed), *International Investment Law and Comparative Public Law* (Oxford University Press 2010) 450

[1198] See, *CMS* (n 584) [175].

consequences. Accordingly, additional liability under the strict conduct approach does not reflect the inefficiency of government conduct. It is also relevant that offering unduly broad protection to foreign investment is likely to entail greater net economic costs than offering unduly narrow protection, on account of the availability of other forms of legal protection for foreign investment. For both reasons, the legal rights approach, with its narrower scope of liability, is likely to encourage investors to make more efficient investment decisions.

7.3.3.2 Distributive consequences

The previous section argued that preferring the strict conduct approach to the legal rights approach is likely to entail net economic costs. Given that the broader protection of the strict conduct approach is likely to benefit foreign investors, these costs would be borne by actors within the host state. This pattern of costs and benefits is likely to be regressive on egalitarian grounds in states that are broadly democratic. Moreover, the additional benefit to foreign investors at the expense of other actors associated with the strict conduct approach cannot be justified by political process theory. Liability for breach of an investor's expectations under the strict conduct approach is independent of whether the investor was singled out to bear a loss caused by a state's change in position.[1199]

Furthermore, the protection of expectations based on unilateral statements cannot be justified by libertarianism. Expectations based on unilateral statements are neither rights nor entitlements owned by the investor under domestic law. (If expectations were so protected, an IIT claim could rely on a specific legal right vested under the domestic legal system when a state makes a unilateral statement, without having to rely on the statement itself as the basis for liability under the FET standard.) This is an important point of contrast with the legal

[1199] *National Grid* (n 608) [176]-[179].

rights approach. The protection of legal rights vested in the investor can be justified – indeed, is required – by libertarian theories of justice.

7.3.3.3 Realisation of human rights and environmental conservation

Both approaches provide similar levels of certainty to government decision-makers about the contours of liability under the FET standard for interference with an investor's legitimate expectations. Therefore, any difference between the chilling effect of the strict conduct and the legal rights approach could only stem from the greater scope of liability under the strict conduct approach. Government measures that give rise to liability are more likely to be chilled than those that do not; and under the strict conduct approach more new measures and changes in policy will give rise to liability than under the legal rights approach. That said, the difference in chilling may be relatively small. To the extent that liability for effective environmental and human rights measures is excluded by the balancing tests built into the strict conduct approach,[1200] it would decrease the additional chilling caused by extension of the scope of the doctrine to departures from unilateral statements.

7.3.3.4 Respect for the rule of law

Assessment of the consequences of the two approaches for respect for the rule of law in host states is more speculative. Assuming that host states do internalise IIT protections to some extent, the key issue is whether liability for breach of a unilateral statement under the strict conduct approach turns on the degree of a state's compliance with the rule of law. If disregard of the rule of law made liability more likely (and respect for it made liability less likely) it would, at least, be arguable that the strict conduct approach encouraged respect for the rule of law.

[1200] *Duke Energy* (n 613) [340]; *Biwater* (n 485) [601]; *Saluka* (n 165) [305].

A government's departure from a clear and specific unilateral statement may, but does not necessarily, offend Razian principles. The primary question is whether the domestic legal regime has open, prospective, clear and relatively stable rules concerning the legal (in)significance of unilateral statements. If it is clear that a unilateral statement is legally insignificant, then breach of such a statement is entirely consistent with the principle that the law should be knowable.[1201] Razian concerns only arise if domestic law is uncertain as to the legal significance of statements, or if the departure from a previous statement is an exercise of discretion under law that was not controlled by open, stable, clear and general rules. Under the strict conduct approach, the determination of liability is somewhat sensitive to these issues. The legal position of the investor is one factor that weighs in the determination of whether an expectation is reasonable.[1202] On the other hand, under this approach a state may still be liable for breach of unilateral statement in a context where the legal insignificance of the statement is clear, obvious and undisputed.[1203]

7.3.3.5 FDI flows

In the absence of empirical evidence of a causal link between IITs and FDI flows, it seems unlikely that nuances in the level of IIT protection would affect FDI flows. However, it is still useful to consider the implications of theories that link IITs to FDI. Commitment theory implies that IIT protections that allow investors to enforce the terms of bargains they have made with the host state are likely to increase flows of FDI. Depending on the circumstances, specific and clear unilateral statements made by host states could be conceived of as components of an overall bargain negotiated and agreed between prospective investors and the host state. To the extent that the unilateral statements protected by the strict conduct

[1201] Raz (n 113) 198.

[1202] *Biwater* (n 485) [601].

[1203] See, *National Grid* (n 608) [177].

approach do emerge from informal bargaining processes, this approach could plausibly lead to greater FDI flows.

7.3.3.6 Overall evaluation

It is likely that the strict conduct approach will engender somewhat greater respect for the rule of law in host states and marginally increased FDI. These conclusions are tentative. Both rely on theoretical arguments that are premised on assumptions about the operation of causal mechanisms that link the content of IIT protections to particular consequences. None of these underlying assumptions has been empirically verified. In contrast, it is likely that the strict conduct approach would decrease economic efficiency, both on account of giving foreign investors greater legal rights than domestic investors, and by virtue of inducing moral hazard on the part of foreign investors. This would be likely to entail net costs within the territory of the host state and benefits to foreign investors – a pattern of distributive consequences that cannot be justified by any theory of justice considered in this thesis. Furthermore, it would involve a minor increase in regulatory chill, implying reduced realisation of human rights and environmental conservation. On balance, the legal rights approach is the more desirable level of protection of foreign investors' legitimate expectations.

7.3.4 Conclusion: the most desirable level of protection of legitimate expectations

This section has argued that the legal rights approach is the most desirable level of protection of investors' legitimate expectations of the four options considered. It judged the legal rights approach to be more desirable than the strict conduct approach on the grounds that it is likely to lead to greater economic efficiency, a distribution of income that is more desirable according to all the theories of distributive justice considered in this thesis, and greater realisation of human rights and environmental conservation. This section has also argued that increasingly expansive protection of investors' legitimate expectations through IIT protections are progressively less desirable. There are few grounds for preferring the

permissive conduct approach to the strict conduct approach and no coherent justifications for preferring the business plan approach to the permissive conduct approach.

7.4 Which of the three levels of protection of foreign investment from procedural unfairness is most desirable?

Chapter 5 identified three interpretations of the procedural element of the FET standard:

i) A narrow approach, based on *Genin*, in which procedural unfairness must be aggravated either by being intentional or by having led to an outcome that cannot be justified on substantive grounds for it to breach the FET standard;

ii) An intermediate approach, based on *Chemtura*, in which procedural unfairness is sufficient to breach the FET standard if it is 'both serious itself and material to the outcome' of an administrative process;

iii) An exacting approach, based on the detailed set of procedural and transparency requirements outlined in *Tecmed*.

Relying on the normative framework developed in Chapter 4, this section infers and evaluates the likely consequences of each approach if it were adopted in future IITs. This section begins by comparing the narrow approach to the intermediate approach. It then compares the intermediate approach to the exacting approach.

7.4.1 The narrow approach vs the intermediate approach

The key difference between the narrow and the intermediate approaches is the threshold of liability. Under the narrow approach only 'extreme' procedural unfairness can breach the FET standard and, even then, only when aggravated by being intentional or by having led to an outcome that cannot be justified on substantive grounds. Under the intermediate approach procedural unfairness would entail liability if it were 'both serious itself and material to the

outcome' of an administrative process.[1204] In the narrow approach, procedural fairness seems to be tied closely to notions of good faith in the conduct of domestic procedure. Under the intermediate approach, procedural fairness refers to a more specific set of characteristics of domestic procedures: notice, hearing, timeliness, objectivity and lawfulness in administrative decision-making; a similar standard of conduct in contractual negotiations; and a requirement of transparency – that is, that legal rules be capable of being known. This section examines whether the lower threshold and broader grounds of liability imposed by the intermediate approach would be desirable.

7.4.1.1 Efficiency

Neither the narrow nor the intermediate approach determines the extent of procedural fairness to which a foreign investor is entitled by reference to the treatment of domestic investors. Thus, there is a risk that both approaches would confer greater rights on foreign investors and, therefore, cause economic inefficiency. This risk can be dismissed so far as the narrow approach is concerned; its minimal protections would not go beyond what is provided in the domestic law of the vast majority of host states. An analysis of the intermediate approach is less clear-cut and is complicated by potential variations in the degree of procedural fairness to which individuals are entitled in different national legal systems. While it seems unlikely that the intermediate approach confers significantly greater protection than domestic investors would be entitled to in Western legal systems,[1205] no study has yet compared the procedural element of the FET standard to Chinese or Islamic legal systems. In any case, the remedial provisions associated with the intermediate approach – a right to compensation for procedural unfairness – may place foreign investors in a better position than domestic investors even in

[1204] *Chemtura* (n 514) [148].

[1205] Giacinto della Cananea, 'Equivalent Standards under Domestic Administrative Law' in Federico Ortino and others (eds), *Investment Treaty Law: Current Issues II* (British Institute of International and Comparative Law 2007) 155.

Western states.[1206] On this basis, the intermediate approach is likely to reduce allocative efficiency.

To the extent that host state decision-makers internalise the procedural element of FET, the intermediate approach may lead to other economic benefits. A state's compliance with the obligation to ensure that laws are capable of being known would improve investors' ability to accurately assess the benefits and risks associated with prospective investment projects. All things being equal, this would lead to more efficient investment decisions. Under the intermediate approach, serious unfairness can result from proceedings where decision-making is fundamentally biased, lacks an evidentiary basis or fails to consider the interests of the investor (when the investor is directly and substantially affected by the decision). Such procedures are more likely to lead to decisions that are substantively inefficient, because the decision-maker has failed to reflect on the full array of costs and benefits of the decision. If the intermediate approach discouraged such procedural conduct it would be likely to improve the efficiency of government decisions.

7.4.1.2 Distributive consequences

The previous section argued that it is difficult to predict whether the intermediate approach would create net economic benefits. Therefore, while it is clear that the intermediate approach would benefit foreign investors on account of providing greater protection, it is unclear whether it would entail net costs for host states. Political process theory provides a limited justification for these benefits that would accrue to investors under the intermediate approach. In Chapter 4, I argued that there is no evidence that foreign investors are a *general* class of actor that suffers practical disadvantage in host state decision-making processes. So the non-contingent protections provided by the intermediate approach cannot be seen as

[1206] van Harten, *Investment Treaty Arbitration and Public Law* (n 19) 106.

redress for systematic exclusion of foreign investors. However, foreign investors may well suffer specific instances of practical disadvantage. While liability under the intermediate approach does not turn on an assessment of whether the foreign investor was denied the opportunity to participate in a domestic decision-making process that was available to other affected constituencies, it is at least arguable that findings of serious unfairness by a non-contingent standard will often correlate with such situations.

7.4.1.3 Realisation of human rights and environmental conservation

Liability under the procedural element of FET does not turn on the substantive content of government conduct. The procedural element of the FET standard would permit a host state to introduce any human rights or environmental measure, so long as the procedures by which the measure was introduced were fair. As such, there is unlikely to be any direct regulatory chill caused by any level of protection from procedural unfairness. Chilling could only occur indirectly, to the extent that the risk of liability for procedural shortcomings in the introduction of new measures were so acute that it had the effect of dissuading decision-makers from adopting particular types of substantive measures. This is clearly not a risk under the narrow approach. Nor is it likely to be a significant risk under the intermediate approach. The standard under the intermediate approach is 'not procedural perfection',[1207] it would impose liability only for serious unfairness.[1208] This approach would also allow the host state flexibility in the way it provides this minimum standard of fairness, as liability only arises if a procedure is unfair overall, allowing for mechanisms of review and correction under domestic law. It is unlikely that decision-makers who were aware of the procedural requirements of the intermediate approach would be discouraged from introducing particular substantive measures.

[1207] *AES* (n 775) [38].

[1208] *Chemtura* (n 514) [148].

7.4.1.4 FDI flows

Neither the narrow nor the intermediate approach deals with the enforceability of agreements between the host state and foreign investors. Hence, commitment theory does not provide a reason to think that either approach will affect FDI flows. Signalling theory raises more challenging issues. To the extent that a given level of protection places greater costs on states with 'bad governance', it may discourage such states from remaining parties to IITs, which – in turn – would allow foreign investors to infer that a state has 'good governance' from the fact it has become (and remains) party to an IIT. Chapter 4 noted reasons to doubt that such complex and indirect causal mechanisms operate in practice.[1209] Nevertheless, for the sake of completeness, it should be noted that signalling theory may give some very tentative support to an association between the intermediate approach and increased FDI flows. The existence of such an effect would depend on the ability of this approach to place additional costs on states that do not respect the rule of law.

7.4.1.5 Respect for the rule of law

The primary mechanism by which IIT protections might affect the degree of respect for the rule of law in host states is through internalisation of these protections by decision-makers and law-makers. Assuming that both approaches are internalised to some extent, the intermediate approach would be likely to lead to greater respect for the rule of law. Liability under the intermediate approach is closely linked to a basic level of compliance with Razian principles. Raz's conception of the rule of law includes the requirement that a state act according to law and that a state observe principles of natural justice – '[o]pen and fair hearing, absence of bias and the like'.[1210] Liability under the intermediate approach turns on whether a state's conduct was a serious departure from similar principles, particularly

[1209] Text following n 458.

[1210] Raz (n 113) 201.

principles of lawfulness, notice and fair hearing in administrative proceedings. Transparency, in the sense that laws are capable of being known, is also fundamental to the Razian conception the rule of law. The intermediate approach places an obligation of transparency, understood in this sense, on host states. As a state would be able to avoid liability under the intermediate approach by showing that it has acted consistently with the foregoing principles, this approach provides a structure of liability that is more likely to encourage respect for the rule of law.

7.4.1.6 Overall evaluation

There is little to distinguish the expected consequences of the narrow and intermediate approaches for the realisation of human rights and environmental conservation, or for FDI flows. A conclusion regarding their relative desirability turns on assumptions regarding the likely extent of internalisation of IIT protections by host state's decision-makers and law-makers. If IIT protections are internalised, the intermediate approach is likely to lead to greater respect for the rule of law and slight improvements in economic efficiency. The greater the degree of internalised compliance, the more significant these consequences would be. The potential improvements in the respect for the rule of law justify a preference for the intermediate approach. That said, this conclusion should be refined if future evidence relevant to assumptions about the degree of internalisation of IIT protections comes to light.

7.4.2 The intermediate approach vs the exacting approach

There is a marked difference between the threshold of liability under the intermediate and exacting approaches. Under the exacting approach, any procedural unfairness would require compensation. The fact that a domestic legal system provides mechanisms to redress such unfairness would not appear to be relevant. Under the intermediate approach, procedural unfairness must be serious and material to require compensation. The scope of host states' procedural obligations is also broader under the exacting approach. It includes requirements

to initiate fair proceedings to consider investors' contractual proposals; and to provide certainty to investors about the way that existing laws will be applied in the future. This section examines whether the lower threshold and broader grounds of liability imposed by the exacting approach are desirable.

7.4.2.1 Efficiency

The exacting approach imposes liability for failure to comply with a set of non-contingent procedural obligations on the state. It is likely to confer legal protection on foreign investors that goes well beyond the entitlements of other investors under domestic law. This result is likely to reduce economic efficiency. An investor's entitlement to force a state to enter contractual negotiations is particularly concerning from an efficiency standpoint. Bargaining between two parties is likely to increase economic efficiency to the extent it leads to mutually beneficial agreement. If a mutually beneficial agreement cannot be reached – that is, if there is no possible agreed course of conduct that is mutually beneficial – the most efficient outcome is for *no* agreement to be reached. Thus, an important procedural prerequisite for maximising efficiency through bargaining is the ability of each party to reject proposals that are to its obvious detriment, without providing a full administrative hearing. The ability to reject proposals prevents waste of resources when no efficient bargain is possible, and focuses the attention of both parties on those options that might be mutually beneficial. The requirement under the exacting approach that host states give serious and fair consideration to foreign investors' contractual proposals is likely to reduce economic efficiency.

7.4.2.2 Distributive consequences

The previous section argued that preferring the strict conduct approach to the legal rights approach is likely to entail net economic costs. Given that the broader protection of the strict conduct approach is likely to benefit foreign investors – the exacting approach demands a standard of 'perfect public regulation in a perfect world' that even diligent host states are

likely to find difficult to satisfy[1211] – these costs will be borne by actors within the host state. This pattern of costs and benefits is likely to be regressive on egalitarian grounds in states that are broadly democratic. The benefit to foreign investors cannot be justified by libertarian theory, as it does not follow from the protection of property rights. Nor can the additional scope of liability under the exacting approach be justified by political process theory. The exacting approach is not concerned with equalising the influence of foreign and domestic constituencies over domestic decision-making. Under this approach, a state could incur liability in circumstances where a foreign investor has significantly greater influence over domestic decision-making than domestic constituencies.

7.4.2.3 Realisation of human rights and environmental conservation

Each of the three alternative levels of protection from procedural unfairness permit a host state to introduce human rights and environmental measures, so long as the procedures by which the measures are introduced are fair. As such, there is unlikely to be any direct regulatory chill caused by the procedural element. Chilling could only occur indirectly, to the extent that the risk of liability for procedural shortcomings in the introduction of new measures were so acute that it had the effect of dissuading decision-makers from adopting particular types of substantive measures. This risk is far more serious under the exacting approach than the intermediate approach. The exacting approach imposes a requirement that, at the time it makes its investment, an investor should be able to determine the laws that will govern its investment for the entire length of the project.[1212] While this is phrased as a procedural obligation, it is one that would foreclose a host states' ability to make *substantive* legal and policy changes, so far as they affect an existing foreign investment. Any new environmental or human rights measure would entail the liability of the host state, to the

[1211] Douglas, 'Nothing if Not Critical' (n 24) 28.

[1212] *Tecmed* (n 484) [154].

extent it caused loss to an investment. As host states are more likely to abandon measures that give rise to liability than those that do not, the exacting approach is likely to be associated with greater regulatory chill.

7.4.2.4 FDI flows

Neither the intermediate nor the exacting approach deals with the enforceability of agreements between the host state and foreign investors. Hence, commitment theory does not provide a reason to think that either approach would affect FDI flows. Signalling theory raises more challenging issues. Any possibility that the exacting approach would increase FDI would depend on its ability to penalise states that do not respect the rule of law.[1213]

7.4.2.5 Respect for the rule of law

Neither approach would be likely to affect the respect for the rule of law in host states, unless it were internalised by decision-makers and law-makers. Assuming that both approaches were internalised to some extent, the key issue is whether a state's additional liability under the exacting approach is linked to failure to respect the rule of law. The principles embodied in the notion of procedural fairness – in both the intermediate and exacting approaches – are closely linked to Raz's conception of the rule of law. The key causal question is whether holding a state liable for *any* procedural unfairness is likely to encourage greater respect for the rule of law. It is doubtful that it would. If internalised, the exacting approach may encourage primary decision-makers to respect Razian principles, yet discourage the development of a legal system based on the rule of law. Unlike the exacting approach, liability under the intermediate approach turns on a complete assessment of the investor's treatment: including complementary mechanisms under domestic law that give the investor an opportunity to be heard, to ensure that decision-making is lawful, evidence-based and

[1213] Text to n 1216.

unbiased. As such, it seems that the intermediate approach would be more likely to act as a complement, rather than a substitute for, the development of the rule of law in host states.[1214]

Moreover, in important respects liability under the exacting approach does not turn on whether a state has complied with the rule of law. The requirement under the exacting approach that a state correct an investor's misunderstanding of the law imposes an obligation greater in scope and different in character to the obligation to ensure that laws are clear and capable of being known.[1215] The requirement that it should be possible to know the way in which laws will be applied in the future goes well beyond the principle of certainty embodied in the rule of law. Raz is surely right that '[i]t is humanly inconceivable that law can consist only of general rules and very undesirable that it should.'[1216] Governance by law requires 'particular legal orders' – conferrals of discretionary power on decision-makers to address particular problems. Respect for the rule of law requires that discretionary power should only be exercised to the extent that it is conferred by law; and that it be constrained by open, stable and general rules governing its exercise. The fact that a foreign investor does not know how a future discretion will be exercised is entirely consistent with the rule of law, so long as the investor is capable of knowing the rules and procedures that will govern its exercise. That a state may act consistently with the rule of law and still incur liability under the exacting approach makes it unlikely that the exacting approach will encourage greater respect for the rule of law than the intermediate approach.

[1214] Ginsburg (n 120) 119, arguing, in a different context, that IITs may either complement or substitute for the development of respect for the rule of law in host states.

[1215] *Metalclad* (n 271) [76].

[1216] Raz (n 113) 197.

7.4.2.6 Overall evaluation

There are no reasons to prefer the exacting approach to the intermediate approach. It is unlikely to lead to greater FDI, likely to lead to a distribution of costs and benefits that cannot be justified by any theory of distributive justice considered in this thesis, and, if anything, it seems likely to reduce respect for the rule of law in host states. Moreover, there are strong grounds for preferring the intermediate approach. It is likely to lead to greater economic efficiency; and less chilling of effective human rights and environmental regulations. Overall, it is clearly a more desirable level of protection from procedural unfairness than the exacting approach.

7.4.3 Conclusion: the most desirable level of protection from procedural unfairness

This section has argued that the intermediate approach is the most desirable level of protection from procedural unfairness. It has identified strong grounds for preferring the intermediate approach to the exacting approach. The comparison of the intermediate to the narrow approach was more finely balanced. The overall preference for the intermediate approach to the narrow approach was based on the assumption that the procedural element of the FET standard is internalised in host states to some extent.

7.5 Which of the two levels of protection of foreign investment from substantive irrationality is most desirable?

Chapter 5 identified two interpretations of the substantive element of the FET standard. According to both interpretations, conduct must be capable of justification by a rational policy and be a reasonable attempt to achieve that policy. Neither approach is fully doctrinally developed, in that neither has developed a comprehensive theory of the objectives that are ‘rational’, nor a precise articulation of the standard of review demanded by the

requirement of a reasonable connection between means and ends. However, each approach is sufficiently developed to be sketched as an alternative level of protection, capturing a key point of contrast: the scope of states' freedom to define their own policy objectives as rational. The two approaches are:

i) a state is entitled to a margin of appreciation in its choice of policy objectives; and, specifically, politicisation of an objective does not indicate irrationality.

ii) a tribunal should scrutinise a state's choice of policy objective; and, specifically, politicisation of an objective does indicate irrationality.

Relying on the normative framework developed in Chapter 4, this section infers and evaluates the likely consequences of each approach if it were adopted in future IITs.

7.5.1 The margin of appreciation approach vs the politics-as-irrationality approach

The key difference between the two approaches is the degree of deference shown to a state's choice of policy objective. The key normative question is whether a doctrinal presumption that politically motivated conduct is irrational is desirable. This difference between the approaches, while apparently minor, is of considerable practical significance. In most arbitral decisions involving substantive review, the impugned conduct was partially motivated by political pressures on the host state. These decisions are likely to be broadly representative of future scenarios in which the substantive element of the FET standard is applicable. The doctrinal significance of politicisation, thereby, becomes central to the extent of a state's liability for conduct that is substantively irrational.

7.5.1.1 Efficiency

The additional scope of liability under the politics-as-irrationality approach does not turn on an assessment of whether domestic investors are protected from politically motivated conduct

under domestic law. As a result, this approach would putting risk foreign investors in a better legal position than their competitors, leading to allocative inefficiency. More generally, a liability rule is likely to encourage more efficient investment decisions to the extent that it provides compensation for inefficient government conduct but no compensation for efficient government conduct.[1217] Extending liability to politically motivated conduct is unlikely to make the extent of a state's liability better correlate with whether the conduct in question is inefficient. This is because politicisation does not automatically entail inefficiency.

This point is best illustrated by distinguishing two fact scenarios that might both be described as 'politicised'. In the first, a well-connected and politically powerful minority's influence motivates government conduct; in the second a broad-based or populist campaign motivates government conduct. The former sort of politicisation is more likely to lead to inefficient decisions, as it encourages decision-makers to overvalue the costs and benefits of a decision that accrue to the particular minority. If anything, the latter sort of politicisation would be associated with more efficient decisions, as populist and majoritarian movements provide a means of aggregating costs and benefits that are spread thinly over a wide range of individuals, and encourage decision-makers to properly value those costs.[1218] Liability under the politics-as-irrationality approach is not sensitive to this distinction, or any other proxy for the efficiency of government conduct. On this basis, it is unlikely to improve the efficiency of investment decisions.

[1217] Text to n 311.

[1218] There is an extensive literature arguing that government decision-makers tend to undervalue diffuse costs, as compared to those than costs that fall on organized minorities, see: George Stigler, 'The Theory of Economic Regulation' (1971) 2 Bell Journal of Economics and Management Science 13; Sam Peltzman, 'Toward a More General Theory of Regulation' (1976) 19 Journal of Law and Economics 211.

7.5.1.2 Distributive consequences

The politics-as-irrationality is likely to benefit foreign investors, given that it would involve a broader entitlement to compensation. Without needing to determine whether such benefits entail correlative costs to the host state, it is clear that these benefits to the foreign investor would not be justified by libertarian theory, as the extent of the state's liability is unrelated to the question of whether the state has interfered with the investor's property rights.

The evaluation of the likely distributive consequences of the two approaches according to political process theory brings the enquiry onto more complex normative terrain. Political process theory suggests that it is unfair for states to impose losses on minorities who were at a practical disadvantage in decision-making processes, and that it is unfair for government decisions to arbitrarily single-out particular minorities to bear losses. Politicisation is, at most, an imperfect proxy for the former. The existence of political controversy or activism surrounding the introduction of a new measure is not direct evidence that a foreign investor was at a disadvantage in the decision-making process as compared to other interested constituencies. Such exclusion could only be identified by an inquiry into whether an investor had been precluded from making representations or lobbying against the impugned measure.

The second distributive norm derived from political process theory – that individuals should not be arbitrarily singled-out to bear losses – is not concerned with the objectives that motivate government conduct as such. Rather, it is concerned with the allocation of losses associated with the achievement of particular policy objectives. It requires that losses be allocated on a rational basis and provides a fairness justification for compensation when there is no reasoned basis for the allocation of loss associated with a measure (that may well pursue a rational objective). Liability under the politics-as-irrationality approach does not turn on an assessment of whether a foreign investor has been arbitrarily singled out, as it does not focus

on the allocation of loss associated with a measure. Moreover, politicisation of decision-making is an unreliable proxy for arbitrary allocation of loss. Consider, for example, an admittedly politically motivated ban on the dumping of cyanide in rivers. Such a measure would not *arbitrarily* single-out a foreign-owned gold mine that is the only actor currently dumping cyanide in rivers. The investment bears the full burden of loss associated with the measure but this allocation of loss is rational in light of the objective of the measure. The loss could not equally have been allocated to other mines that do not dump cyanide in rivers. Accordingly, political process theory would not require compensation. Overall, it is difficult to justify the *general* scepticism of politically motivated conduct under the politics-as-irrationality approach by reference to the specific concerns about horizontal discrimination that underpin political process theory.

7.5.1.3 Realisation of human rights and environmental conservation

The politics-as-irrationality approach is likely to cause significantly more regulatory chill than the margin of appreciation approach. In Chapter 4 I argued that regulatory chill is most likely to occur in situations where investors initiate, or threaten to initiate, arbitration in response to a new government measure. In these situations, measures that would give rise to liability under IITs are more likely to be chilled than measures that would not. The decisive question, then, is whether the politics-as-irrationality approach extends a state's liability to measures effective in realising human rights or environmental conservation objectives that would not incur liability under the margin of appreciation approach. It is highly likely that it does.

Political activism and controversy is one mechanism by which human rights and environmental concerns are brought to the attention of law-makers. These norms are non-economic in character, so their realisation through public policy typically relies on political,

as opposed to economic, persuasion or pressure.[1219] This observation is sufficient to show that some measures that are, subjectively, politically motivated will be, objectively, concerned with the realisation of human rights or environmental conservation. There is no reason to think that such populist or politically motivated measures would be ineffective in realising environmental conservation or human rights. The link between the subjective motivation (political or otherwise) of government conduct and its effectiveness in achieving normatively desirable consequences raises complex questions about decision-making, the answers to which are likely to vary among decision-makers within and between countries. However, for the purpose of evaluating alternate liability rules, the issue is not whether political pressure always leads to the most effective measures for realising human rights and achieving environmental conservation, but whether political pressure sometimes encourages decision-makers to introduce somewhat effective measures. There are strong grounds for concluding that it does. The presumption that politically motivated conduct is irrational is, therefore, likely to entail an increase regulatory chill.

7.5.1.4 Respect for the rule of law

Under both the margin of appreciation and politics-as-irrationality approach a host states' liability arises from the review of government conduct on substantive grounds. A state's liability does not turn on the formal and procedural characteristics of the impugned conduct under either approach. Specifically, a state's additional liability for politically motivated conduct under the politics-as-irrationality approach does not depend on whether a politically motivated measure was introduced lawfully, embodied in a form that is prospective, open and clear and applied consistently with principles of natural justice. As such, this additional scope of liability is unlikely to increase respect for the rule of law in host states.

[1219] Sen, *Development as Freedom* (n 187) 182.

7.5.1.5 FDI flows

Neither the margin of appreciation approach nor the politics-as-irrationality approach concerns the enforcement of agreements made between the host state and foreign investors. Accordingly, commitment theory suggests that neither will affect the flow of FDI into host states. Signalling theory implies a highly indirect causal link between IITs and FDI, relying on the ability of IIT protections to place greater liability on states with 'bad governance' than those with 'good governance'. The foregoing analysis shows that imposing liability for politically motivated conduct does not correlate with liability for economically inefficient conduct; or liability for disregard of the rule of law. There are no grounds to think that extending liability to politically motivated conduct allows IITs to better operate as good governance signals.

7.5.1.6 Overall evaluation

Compared to the margin of appreciation approach, a state's additional liability under the politics-as-irrationality approach would be likely to significantly increase the chilling effect of desirable human rights and environmental measures and, if anything, to decrease economic efficiency. It is likely to lead to a complex pattern of costs and benefits that cannot be justified by libertarian theory and are difficult to justify by political process theory. The additional scope of liability under the politics-as-irrationality approach is unlikely to affect FDI flows or the degree of respect for the rule of law in host states in either direction. Of the two levels of protection against substantive irrationality, the margin of appreciation approach is more desirable.

7.5.2 Conclusion: the most desirable level of protection from substantive irrationality

This section has argued that the margin of appreciation approach is the most desirable level of protection from substantive irrationality. It has identified several justifications for

preferring the margin of appreciation approach, while failing to find any clear justification for preferring the politics-as-irrationality approach.

7.6 Which of the five levels of protection against indirect expropriation is the most desirable?

Chapter 6 identified five alternative interpretations of the concept of indirect expropriation in arbitral decisions under IITs. They are:

i) The *Metalclad* approach: that indirect expropriation is defined by its effect on the economic value of the investment;

ii) The *Pope & Talbot* approach: that indirect expropriation is defined by a substantial deprivation of the investor's property interests in the investment

iii) The *Methanex* approach: that indirect expropriation is subject to an exception for measures with certain characteristics

iv) The characterisation-as-balancing approach: that identifying indirect expropriation requires a tribunal to balance an assessment of the effects of the measure with a consideration of a range of the measures' characteristics.

v) The *Tecmed* approach: that indirect expropriation is defined by severe loss of economic value of the investment, subject to proportionality review.

Relying on the normative framework developed in Chapter 4, this section infers and evaluates the likely consequences of each approach if it were adopted in future IITs. Organising the evaluation of these five alternatives poses certain challenges. Unlike the levels of protection derived from the FET standard these five options do not fit neatly along a scale ranging from narrower to broader liability of the host state. As such, it is not possible to evaluate each level of protection in a paired comparison against incrementally more (or less) expansive alternatives.

This section addresses these challenges by first evaluating the relative desirability of protections within each of the three structures of enquiry identified in Chapter 6 – the effects, exception and balancing structures. This narrows the set of alternatives to the most desirable level of protection within each structure of enquiry. These levels of protection are then evaluated against each other. Accordingly, this section begins by comparing the *Metalclad* and *Pope & Talbot* approaches, both of which rely on the effect structure. This evaluation concludes that the *Pope & Talbot* approach is clearly the more desirable. Then, it compares the characterisation-as-balancing and *Tecmed* approaches, both of which rely on the balancing structure. This evaluation suggests that the characterisation-as-balancing approach is the more desirable. Finally, this section compares the *Methanex* approach with the *Pope & Talbot* and characterisation-as-balancing approaches in a three-way comparison. This evaluation concludes that the characterisation-as-balancing and the *Methanex* approaches are more desirable than the *Pope & Talbot* approach, but is unable to come to a final preference between the two.

7.6.1 The *Metalclad* approach vs the *Pope & Talbot* approach

The *Metalclad* approach and the *Pope & Talbot* approach define indirect expropriation exclusively by its effects on an investment. The primary difference between the levels of protection is qualitative in character – the effect on which the enquiry focuses. The *Metalclad* approach looks to loss of economic value of the investment, while the *Pope & Talbot* approach examines the extent of interference with the investor's property interests in the investment. A secondary difference between the two levels of protection is the extent of effect required to constitute indirect expropriation. The *Pope & Talbot* approach requires 'substantial deprivation', a higher threshold than deprivation of a 'significant part' of the value of the investment under the *Metalclad* approach. The practical implication of this second difference is that, even when the qualitative distinction between property interests and

loss of economic value is not relevant (that is, situations where an interference with property interests causes loss of economic value), some measures that amount to indirect expropriation under the *Metalclad* approach would not amount to indirect expropriation under the *Pope & Talbot* approach. Normative evaluation of these approaches focuses on these two points of difference.

Readers may notice that liability under the business plan approach to the FET standard is triggered by state action that interferes with an investor's business plans, which is similar to the *Metalclad* approach's focus on denial of expected economic benefits; and liability under the permissive conduct is triggered by changes to the investor's basic entitlements to use, enjoy and dispose of its investment under the regulatory arrangements at the time the investment, which is similar to the *Pope & Talbot* approach's understanding of deprivation of property interests. However, it is important to note that the *Metalclad* approach is not identical to the business plan approach to legitimate expectations under the FET standard, and that the *Pope & Talbot* approach is not identical to the permissive conduct approach. One key difference is that the threshold of effect on an investment required for a finding of liability is lower under both levels of protection derived from the FET standard than under the corresponding approaches derived from indirect expropriation decisions. This is evinced by the success of FET claims in cases where indirect expropriation claims argued on the same facts fail.[1220]

7.6.1.1 Efficiency

A state's additional liability under the *Metalclad* approach is likely to reduce economic efficiency for two reasons. First, legal protections that place some foreign investors in a better position than other foreign investors are likely to reduce efficiency by interfering with

[1220] eg *Occidental* (n 204); *Bau* (n 818); *MTD* (n 576). For discussion Fietta (n 738) 183.

competitive equality. Liability under the *Metalclad* approach does not turn on an examination of whether the measure that caused economic loss to the foreign investor was discriminatory, or whether equivalent legal protections are available to other investors under domestic law. Second, liability rules that compensate foreign investors for loss caused by efficiency improving government measures are likely to encourage investors to make inefficient investment decisions by inducing moral hazard. A state's additional liability under the *Metalclad* approach is highly likely to induce moral hazard, because it extends compensation to an investor for significant losses caused by government measures regardless of whether the measure is efficient.

7.6.1.2 Distributive consequences

The previous section argued that preferring the *Metalclad* approach to the *Pope & Talbot* approach is likely entail net economic costs. Given that the broader protection of the *Metalclad* approach is likely to benefit foreign investors, this means that these costs will be borne by actors within the host state. This pattern of costs and benefits is likely to be regressive on egalitarian grounds in states that are broadly democratic. Nor can this pattern of distributive consequences be justified by any other theory of distributive justice. The *Metalclad* approach extends the obligation to compensate beyond interferences with property interests to interferences with the expected economic benefits of an investment. This expanded scope of liability cannot be justified by libertarianism's concern for the protection of the bundle of legal entitlements validly acquired by the investor. Moreover, as the *Metalclad* approach does not look to whether the decline of economic value emerged from a political process from which the investor was excluded or whether the investor was arbitrarily singled out to bear the costs of a measure, these distributive transfers cannot be justified by political process theory.

7.6.1.3 FDI flows

The greater scope of liability under the *Metalclad* approach is unlikely to increase FDI flows. Existing empirical evidence suggests that a link between the level of substantive protection and the magnitude and destination of FDI flows is highly unlikely. Even if the adoption of different levels of protection did influence FDI flows, existing theories that purport to explain the causal connection between FDI and IITs provide no reason to think that the *Metalclad* approach would be associated with greater FDI than the *Pope & Talbot* approach. Commitment theory does suggest that protections that allow an investor to enforce bargains it has made with the host state would increase FDI flows. However, the *Metalclad* approach protects the economic value of investment, rather than interests arising out of agreements with the host state.

7.6.1.4 Realisation of human rights and environmental conservation

Empirical evidence concerning the effect of IIT protections on the realisation of human rights and environmental conservation is limited. To the extent it exists, evidence and theory suggest that states are less likely to maintain measures that give rise to liability under an IIT. Under both approaches, liability turns on the effect of a measure on an investment, without reference to whether the measure is effective in realising human rights or environmental conservation. On this basis, it is reasonable to infer that both approaches are likely to cause some regulatory chill. A state's liability under the *Metalclad* approach is broader – in both qualitative and quantitative terms – than under the *Pope & Talbot* approach. Thus, it is likely to be associated with greater regulatory chill of measures that are desirable on human rights and environmental grounds.

Theory also suggests that approaches that reduce uncertainty about the extent of states' liability would tend to reduce regulatory chill, with concomitant improvements in the realisation of human rights and environmental conservation. It is reasonable to assume that it

is easier for a state to ascertain the extent of investors' property interests under existing legal arrangements, and whether a proposed measure would interfere with those interests, than it is for a state to determine whether a proposed measure interferes with the expected economic benefits of an investment. To make a prospective determination about whether a measure would significantly affect the economic value of an investment, the state would require a range of commercial information to which each individual investor is likely to be privy. As such, the *Pope & Talbot* approach provides a host state with greater certainty about the extent of its liability than the *Metalclad* approach, and is likely to be associated with lower levels of regulatory chill.

7.6.1.5 Respect for the rule of law

The primary mechanism by which IIT protections might affect the degree of respect for the rule of law in host states is through internalisation of these protections by decision-makers and law-makers. Assuming that both approaches are internalised to some extent, the key issue is whether a state's additional liability under the *Metalclad* approach is linked to failure to respect the rule. Overall, it is not. Liability under the *Metalclad* approach turns primarily on the extent of economic loss caused by the measure. The determination of whether a state has interfered with a reasonably expected economic benefit does not turn on whether the measure was consistent with the requirements of open, clear and prospective law, nor on whether the state observed the principles of natural justice. Moreover, the *Metalclad* approach would not encourage greater stability in domestic legal systems than the *Pope & Talbot* approach; under the *Metalclad* approach liability stems from interference with expectations of value that are not grounded in the law of the host state, rather than changes to the legal regime governing the investment.

7.6.1.6 Overall evaluation

There are strong arguments for preferring the *Pope & Talbot* approach to the *Metalclad* approach. The former is likely to be more efficient than the *Metalclad* approach, to entail a pattern of distributive consequences that is more consistent with libertarian and political process theories, and, by virtue of causing less regulatory chill, to lead to greater realisation of human rights and environment conservation.

7.6.2 The characterisation-as-balancing approach vs the *Tecmed* approach

Both the characterisation-as-balancing approach and the *Tecmed* approach fall within the balancing structure of enquiry. There are many similarities between the two approaches, yet they differ in meaningful ways. The first difference is the nature of effect that defines a measure as potentially expropriatory: the characterisation-as-balancing approach adopts the *Pope & Talbot* requirement of substantial deprivation of property interests, while the *Tecmed* approach follows the *Metalclad* approach in focusing its analysis of effects on the impact on the economic value of the investment. (However, it should be noted that the *Tecmed* approach demands a higher threshold of economic impact for a measure to be expropriatory than the *Metalclad* approach: 'radical deprivation' of economic value, rather than deprivation 'of a significant part' of an investment's value.) A subsidiary similarity between the *Tecmed* and characterisation-as-balancing approaches is that both agree that the effect of a measure should be assessed in light of an investor's expectations.[1221]

The second difference between the approaches concerns the range of characteristics of a measure that are relevant in the balancing process that occurs when a measure exceeds the threshold of effect necessary for expropriation. The *Tecmed* approach considers only the purpose of the measure, which is balanced against its effect on the investment according to

[1221] *Tecmed* (n 484) [122]; *Fireman's Fund* (n 989) [176].

the principle of proportionality. The characterisation-as-balancing approach considers whether the measure satisfies the standard of means-ends proportionality, as well as whether the measure is non-discriminatory, of general application and applied in good faith in making an overall determination of whether it amounts to indirect expropriation. The normative evaluation of these levels of protection concentrates on these points of difference. In the context of this evaluation, it is important to emphasise that neither approach is self-evidently more favourable to the investor or to the host state. Some measures may require compensation under the characterisation-as-balancing approach but not under the *Tecmed* approach and vice versa.

7.6.2.1 Efficiency

The characterisation-as-balancing approach is likely to lead to more efficient economic outcomes. Liability under this approach is sensitive to whether a measure is non-discriminatory. Making liability referrable to the treatment of domestic investors reduces the disturbance to conditions of competitive equality engendered by IIT protections. In contrast, the *Tecmed* approach establishes a pattern of liability that is more likely to put foreign investors in a better position than other investors.

The characterisation-as-balancing approach is also more likely to encourage more efficient investment decisions on the part of foreign investors. While neither approach seeks to determine whether a measure that affects an investment was efficient, the characterisation-as-balancing approach invites a broader weighing of the benefits and costs of a measure that do not accrue to an investor. In contrast, the means-ends proportionality review under the *Tecmed* approach seeks only to ascertain whether the investor has been forced to bear 'an individual and excessive burden.'[1222] The characterisation-as-balancing approach better

[1222] *Azurix* (n 610) [311].

embodies the principle that investment decisions will be more efficient if investors are compensated for loss caused by inefficient measures, but not for loss caused by efficient measures.

7.6.2.2 Distributive consequences

The previous section argued that preferring the characterisation-as-balancing approach is likely to entail net economic benefits. Regardless of whether this is true, the scope of requirements to compensate under the characterisation-as-balancing better accords with the prescriptions of both libertarianism and political process theory. Liability under the characterisation-as-balancing approach requires interference with an investor's property interests, while liability under the *Tecmed* approach requires severe economic loss. Protection of property interests can be justified by libertarian theory, whereas protection of economic value cannot. Furthermore, political process theory provides grounds to prefer the broader balancing of a measure's characteristics under the characterisation-as-balancing approach to the narrower proportionality enquiry under the *Tecmed* approach. Under the characterisation-as-balancing approach, a finding of liability is sensitive to the determination of whether a measure is non-discriminatory and of general application in a way that means-ends proportionality of the *Tecmed* approach is not. As such, the characterisation-as-balancing approach makes it more likely that a state will be found liable for a measure that discriminatorily singles-out a foreign investor and less likely that non-discriminatory measures of general application that severely affect an investor will result in liability. These grounds for the payment of compensation are consistent with political process theory's concern for protecting investors from being arbitrarily singled-out to bear the costs of a measure.

7.6.2.3 Respect for the rule of law

Theory suggests that adopting different levels of IIT protection is unlikely to have a substantial impact on the degree of respect for the rule of law in host states, and existing evidence is uncertain. This is all the more so in the case of approaches that are as similar as the characterisation-as-balancing and *Tecmed* approaches. Neither approach makes the finding of liability sensitive to whether a measure was consistent with the requirements of open, clear and prospective law, nor on whether principles of natural justice were observed in its introduction. If there is any difference in the consequences of the two approaches for the degree of respect for the rule of law, they are likely to lend support to the characterisation-as-balancing approach. The characterisation-as-balancing approach focuses on interference with property interests, whereas the *Tecmed* approach focuses on the protection of economic value that do not necessarily have a basis within the domestic legal system. As the former approach protects legal interests, it is, if anything, more likely to encourage stability and certainty in the domestic legal system.

7.6.2.4 FDI flows

Little can be said about the consequences of the two approaches for the attraction of FDI. Neither approach concerns the protection of bargains made with the host state, nor enables IITs to act as signals of strong legal institutions. As such, neither commitment theory nor signalling theory offers reasons to think one approach would be associated with greater FDI flows than the other.

7.6.2.5 Realisation of human rights and environmental conservation

In theory, states are less likely to maintain measures that give rise to liability under IITs than those that do not. Both the characterisation-as-balancing approach and the *Tecmed* approach take the purpose of a measure into account in determining whether it amounts to indirect expropriation; under both approaches the fact that a measure's purpose is the realisation of a

human right or the conservation of the environment would weigh against a finding of liability. In this way, both approaches would be associated with less regulatory chill than if they exclusively focused on a measure's effects.

If there are any differences between the approaches' consequences for regulatory chill, they are likely to flow from the degree of certainty each approach provides to decision-makers. On the one hand, the characterisation-as-balancing approach's focus on the property interests of the investor is likely to give regulators greater clarity about the extent of liability under IITs than the *Tecmed* approach's focus on loss of economic value. It is much easier for regulators to determine a foreign investor's legal entitlements under domestic law than to identify the underpinnings of the economic value of a private investment project. On the other hand, means-ends proportionality under the *Tecmed* approach is a more structured, and arguably more certain, criterion of liability than the ad hoc balancing of a number of a measure's characteristics under the characterisation-as-balancing approach. Given these differences between the approaches, it is difficult to determine which provides government decision-makers with more certainty and, therefore, impossible to conclude that one would be associated with greater chilling.

7.6.2.6 Overall evaluation

Neither evidence nor theory provides clear reasons to conclude that one or the other of the characterisation-as-balancing and *Tecmed* approaches has more desirable consequences for FDI flows or regulatory chill. There are only weak and empirically tenuous grounds for distinguishing their consequences for respect for the rule of law in host states; a comparison which, if anything, favours the characterisation-as-balancing approach. However, the pattern of liability associated with the characterisation-as-balancing approach better accords with the tenets of both libertarianism and political process theory than the *Tecmed* approach. The characterisation-as-balancing approach is also more consistent with the principle of

competitive equality among investors and less likely to induce moral hazard, both characteristics that are associated with net economic benefits. With no coherent reasons to prefer the *Tecmed* approach and good reasons to prefer the characterisation-as-balancing approach, the latter is more desirable.

7.6.3 The *Methanex* approach vs the characterisation-as-balancing approach vs the *Pope & Talbot* approach

The previous sections concluded that the *Pope & Talbot* approach was the more desirable of the two levels of protection that look exclusively to a measure's effects; and that the characterisation-as-balancing approach was the more desirable of the two levels of protection that balance a measure's effects against its characteristics. It remains to compare these two approaches to each other and to compare them both to the *Methanex* approach, which adopts an exception structure of enquiry.

This potentially complex three-way comparison is simplified by the fact that assessment of a measure's effects in all three approaches is based on the *Pope & Talbot* approach. Under the *Pope & Talbot* approach, a measure amounts to indirect expropriation if it substantially deprives an investor of property interests in the investment. In the characterisation-as-balancing approach, a measure must constitute a substantial deprivation of property interests in order to be potentially expropriatory;[1223] the same applies under the Methanex approach, so far as decisions under this approach have fleshed out analysis of a measure's effects.[1224] The difference between the three approaches concerns the relevance of a measure's characteristics. Under the *Pope & Talbot* approach they are irrelevant. Under the characterisation-as-balancing approach, a measure's characteristics – particularly, whether it

[1223] *Fireman's Fund* (n 989) [176].

[1224] *Suez and Vivendi* (n 137) [140]; *Chemtura* (n 514) [249].

is non-discriminatory, proportionate, of general application and applied in good faith – are weighed against its effect. Under the *Methanex* approach, a measure that satisfies the criteria of being 'non-discriminatory regulation for a public purpose ... enacted in accordance with due process' and does not breach specific commitments made to the investor does not constitute indirect expropriation.[1225] The normative evaluation that follows examines the consequences of these different views of the relevance of a measure's characteristics in the indirect expropriation enquiry.

7.6.3.1 Efficiency

Differences in the consequences of the three approaches for economic efficiency stem, above all, from the extent to which they place foreign investors in a position of competitive equality with domestic investors. No doubt, some host states do provide investors with protection against indirect expropriation through domestic law. However, the scope of liability imposed by the *Pope & Talbot* approach is not affected by the degree of protection provided by domestic law or the way in which other investors are treated by the host state. The characterisation-as-balancing and *Methanex* approaches fare better in the latter respect, as they make it less likely that a state will be liable for interference with property rights caused by a non-discriminatory measure.

The different levels of protection are also likely to affect economic efficiency to the extent they induce investors to make efficient investment decisions. A key issue is how well each liability rule conforms to the principle that investors should be compensated for loss caused by inefficient government conduct, but not for loss caused by efficient government conduct. The *Pope & Talbot* approach, again, is the least desirable. It directs the indirect expropriation enquiry exclusively to the effect of a measure on the investment, rather

[1225] *Methanex* (n 470) pt IV ch D [7].

requiring an economy-wide reckoning of a measure's costs and benefits. The *Methanex* approach is more desirable, because determining whether a measure satisfies the criteria of the exception to indirect expropriation would entail at least some *de facto* assessment of the benefits of a measure that do not accrue to the investor.[1226] The characterisation-as-balancing approach is likely to best address problems of inefficiency stemming from moral hazard on the part of investors, because it requires a tribunal to make a broad assessment of a measure that will inevitably invite some consideration of its costs and the benefits.

7.6.3.2 Distributive consequences

The previous section has argued that preferring the *Pope & Talbot* approach to either of the other alternatives is likely to entail net economic costs. Given that this provides benefits to foreign investors through broader protection, this implies a net loss to be borne by actors within the host state. This pattern of costs and benefits cannot be justified by political process theory. The *Pope & Talbot* approach does not seek to ascertain whether the investor has been excluded from political processes or whether it has been arbitrarily singled-out to bear the expense of a measure. This is a notable point of contrast with the characterisation-as-balancing and *Methanex* approaches. Under both these approaches the determination of liability is sensitive to assessment of whether the measure in question is non-discriminatory and general in application (the requirement under the Methanex approach that a measure be a 'regulation' should be understood as requirement that the measure be of general application). On the other hand, the uncompromising imposition of liability for measures that interfere with property interests under the *Pope & Talbot* approach conforms better to libertarian theory than the other two approaches.

[1226] This argument has been made in detail in Aisbett, Karp and McAusland, 'Police powers, regulatory taking' (n 66) 381.

7.6.3.3 FDI flows

Given that current empirical evidence casts doubt on the hypothesis that IITs affect FDI flows, there are unlikely to be significant differences in the impact of each of the three levels of protection on FDI flows, if adopted. The theories that purport to link IITs with FDI flows provide only the most tentative reasons for preferring one approach to the others. While none of the approaches purports to protect bargains struck between the host state and foreign investors, the *Methanex* approach does condition the availability of its exception to indirect expropriation on the requirement that a state has not acted in breach of specific commitments made to the investor. However, the same liability for substantial deprivation in breach of specific commitment is provided by the *Pope & Talbot* approach (in the less targeted sense that a substantial deprivation necessarily amounts to indirect expropriation). Moreover, given that the characterisation-as-balancing approach considers whether a measure breaches 'investment-backed expectations', there are likely to be few situations where a substantial deprivation in breach of a specific commitment would not amount to an indirect expropriation.[1227]

7.6.3.4 Realisation of human rights and environmental conservation

Examination of the likely consequences of the three approaches for realisation of human rights and environmental conservation is equally challenging. The question of regulatory chill primarily turns on the extent to which each approach would impose liability for measures that are effective in realising human rights or achieving environmental consequences. It is clear that the *Pope & Talbot* approach is least desirable on these grounds. Unlike the other two approaches, a state is not able to avoid liability for a measure that causes substantial deprivation by showing that it had a human rights or environmental purpose. The *Methanex* approach is probably more desirable than characterisation-as-balancing because it provides a

[1227] *Fireman's Fund* (n 989) [176].

clear exception to measures with certain public purposes – which appear to include environmental and human rights purposes – provided they satisfy other criteria. One caveat to this conclusion arises from the criterion that a measure must not be inconsistent with a specific commitment made to the investor if it is to fall within the *Methanex* exception. This entails the result that effective human rights and environmental measures would still incur liability if they cause substantial deprivation and breach a specific commitment to an investor. However, in light of references in characterisation-as-balancing decisions to 'investment-backed expectations' this is unlikely to be a point of difference between the approaches.

A further question is the extent to which uncertainty associated with the contours of liability under each level of protection could be expected to cause additional chilling of measures that may have been permitted under the level of protection in question. In this respect, the *Pope & Talbot* and *Methanex* approaches fare better than the characterisation-as-balancing approach. Both provide definitions of the contours of a state's liability for indirect expropriation that are clear in principle. The characterisation-as-balancing approach is very different. It requires an *ad hoc* enquiry in which a number of factors are relevant. The outcome of such an enquiry may be very difficult for decision-makers to predict in advance.

7.6.3.5 Respect for the rule of law

The last ground for comparison of the approaches is their consequences for the degree of respect for the rule of law in host states. The primary mechanism by which IIT protections might affect the degree of respect for the rule of law in host states is through internalisation of these protections by decision-makers and law-makers. Assuming that both approaches are internalised to some extent, levels of protection under which liability depends on an assessment of whether the host state has complied with Razian principles are more likely to encourage respect for those same principles. As liability under the *Pope & Talbot* approach is

indifferent to whether a measure that has caused substantial deprivation is consistent with the rule of law, this approach is least likely to advance its realisation. Liability in both the characterisation-as-balancing approach and the *Methanex* approach is somewhat sensitive to Razian concerns. This is more so under the *Methanex* approach than under characterisation-as-balancing. The characterisation-as-balancing approach involves consideration of the procedures by which a measure was adopted only so far as it is incidental to determination of whether a measure was enacted in good faith. In contrast, measures adopted in accordance with due process will not incur liability under the *Methanex* approach, provided other criteria are satisfied. Although none of the decisions within the *Methanex* approach elaborates on the meaning of 'due process', it presumably embodies a minimum requirement of legality and, perhaps, further requirements of natural justice.

7.6.3.6 Overall evaluation

Overall evaluation of these three alternatives requires qualitative judgement about the relative significance of a set of incommensurable likely consequences. In my judgement, the *Pope & Talbot* is the least desirable of the three overall. It is the least desirable in terms of its net economic benefits, respect for the rule of law and realisation of human rights and environmental conservation. The only coherent argument for preferring the *Pope & Talbot* approach to either of the other alternatives is that it better accords with the prescriptions of libertarian theory.

Comparison of the characterisation-as-balancing approach and the *Methanex* approach is more finely balanced. This section has argued characterisation-as-balancing approach is likely to lead to greater economic benefits, while the *Methanex* approach is likely to be associated with realisation of human rights and environmental conservation and respect for the rule of law. These points of difference in inferred consequences are all relatively minor and – particularly, in the case of analysis of consequences for respect for the rule of law –

depend on causal inferences about IIT protections for which there is little empirical evidence. In my view there are not sufficient grounds to express an overall preference for one approach. This is all the more so since the consequences of the *Methanex* approach would depend on the meaning of legal concepts internal to the approach, such as 'public purpose' and 'due process', that are not fully specified by this option as presented in this thesis.

7.6.4 Conclusion: the most desirable level of protection from indirect expropriation

This section has argued that the characterisation-as-balancing approach and the *Methanex* approach are the most desirable level of protections, although it has been unable to justify a preference between the two. This section has not sought to rank the remaining level of protection among themselves. However, the argument that there is no consequence-based rationale for preferring the *Metalclad* approach to the *Pope & Talbot* approach – the *Pope & Talbot* approach, itself, not being one of the most desirable approaches – strongly suggests that the *Metalclad* approach would emerge as the least desirable if a full set of comparisons were performed.

7.7 General Conclusions I – the implications of this thesis for states

Chapter 5 and Chapter 6 have shown that arbitral tribunals have interpreted FET and indirect expropriation provisions in a number of distinct ways. It is sometimes suggested that these interpretative disagreements were confined to earlier cases and that a more consistent approach has since emerged.[1228] This is not so. Chapters 5 and 6 show that tribunals continue to interpret IIT protections as entailing markedly different levels of protection. All fourteen approaches identified in this thesis (nine approaches to different elements of the FET standard and five approaches to indirect expropriation) have been applied in decisions

[1228] Stephan Schill, 'W(h)ither Fragmentation: on the Literature and Sociology of International Investment Law' (2011) 22 European Journal of International Law 875, 890-894.

rendered since 2007. Indeed, in some areas, such as the extent to which the FET standard protects an investor's legitimate expectations, the range of doctrinal disagreement between tribunals has significantly increased over the past decade. Chapters 5 and 6 constitute a sustained argument for these propositions.

This thesis does not, however, attempt to determine the 'correct' interpretation of these provisions. Rather, the thesis takes different approaches as articulating different levels of protection that might be adopted in the future. The conclusions of this thesis are relevant to states that wish to provide a greater degree of clarity as to the level of substantive protection provided to foreign investment by IITs than is currently provided. This thesis is highly relevant to such states, as it has argued that there are strong normative grounds for preferring certain levels of protection to other alternatives.

Up to this point, the thesis has considered the level of protection that should be provided by IITs, rather than the mechanics of legal reform required to ensure the preferred level of protection. In this section, the focus of this thesis moves to the latter question. It reviews three possible courses of action for states, which might be adopted individually or in combination: changes to the drafting of substantive protections of new IITs; amendments to the substantive protections of existing IITs; and interpretative statements relating to the interpretation of existing IITs.

7.7.1 Drafting of the substantive protections of new IITs

The simplest way for states to adopt a preferred level of protection is to incorporate the new level of protection in new IITs when they are signed. There are few legal constraints on states' ability to define the level of protection to be provided to foreign investment in future IITs. One potential complication could arise if states sought to specify a level of protection in an IIT below that required by customary international law. Chapters 5 and 6 observed that

tribunals have taken different views of the extent of states' obligations under customary international law.[1229] Academic commentary also recognises that this is a subject of considerable disagreement.[1230] That said, no tribunal has interpreted an IIT protection as entailing a level of protection below that required by customary international law. Tribunals that have interpreted existing IIT provisions as entailing what are probably the two lowest levels of protection considered in this thesis – the narrow approach to the procedural element of the FET standard and the *Methanex* approach to indirect expropriation – have justified their views as being consistent with customary international law.[1231] On this basis, all the levels of protection considered in this thesis are consistent with arugable views of what custom requires. Indeed, at least one academic has aruged that states' obligations under customary international law are signifcantly less demanding than any of the levels of protection considered in this thesis.[1232]

Even assuming, *arguendo*, that the preferred level of protection fell below the requirements of customary international law, there would be no obstacle to its inclusion in an IIT. Within the context of the relationship between the parties to the treaty in question, states are free to agree to derogate from general customary international law (subject to constraints

[1229] see sections 5.2.2.1 and 6.2.2.

[1230] Dolzer and Schreuer (n 64) 16; McLachlan, Shore and Weiniger (n 635) 17; Stephen Schwebel, 'The United States 2004 Model Bilateral Investment Treaty: an Exercise in the Regressive Development of International Law' (2006) 3(2) Transnational Dispute Management 1, 4.

[1231] *Glamis Gold* (n 514) [627]; *Methanex* (n 470) pt IV ch D [7].

[1232] Ian Brownlie, *Principles of Public International Law* (7th edn Oxford University Press 2008) 525-528, 530.

of *jus cogens*).[1233] Moreover, it is clear that a state may limit its consent to jurisdiction to investor-state arbitration to the violation of particular protections defined in a treaty.[1234]

More practical problem could arise if a state adopted a lower level of protection in new IITs than it had in previous treaties, only to find that investors were able to rely on more expansive protections in earlier IITs via an MFN clause in the new treaty. States will need to consider the drafting of MFN clauses, if the specification of a given level of protection in a particular treaty is to be effective.

7.7.1.1 The drafting of multilateral investment treaties, model BITs and BITs

The conclusions of this thesis will be of immediate relevance in the drafting of multilateral investment treaties. For example, the Trans-Pacific Partnership Agreement, assuming that it ultimately retains the investment chapter currently being negotiated, will apply to a range of developed and developing states that have very different systems of government.[1235] In determining the level of protection to be adopted in a treaty of this sort, states will need to come to a general view about the level of protection that should be provided to foreign investment. This is precisely the perspective adopted in this thesis.

The conclusions of this thesis are also highly relevant to states in the drafting of model BITs – template negotiating positions to be offered to a range of differently situated states. The perspective of a single state preparing a model BIT may diverge from the general

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[1233] Luigi Condorelli, 'Custom' in Mohammed Bedjaoui (ed), *International Law: Achievements and Prospects* (Martinus Nijhoff 1991) 184; Campbell McLachlan, 'Investment Treaties and General International Law' (2008) 57 Iinternational and Comparative Law Quarterly 361, 374.

[1234] *Case Concerning Oil Platforms (Iran v United States)* Preliminary Objection, Judgment of 12 December 1996, ICJ Rep 803 [38] holding that the US had not consented to the Court's jurisdiction to decide claims relating to the breach of customary international law on the use of armed force, and that the submission to jurisdiction was limited to the scope of the treaty. Similarly, *Case Concerning Oil Platforms (Iran v United States)* Judgment of 6 November 2003, Separate Opinion of Judge Higgins ICJ Rep 225 [52].

[1235] Office of the United States Trade Representative (n 42).

perspective adopted in this thesis to the extent that the state in question is particularly concerned with the likely consequences of adopting a given level of protection for the state itself. If the state in question is a democratic, developing country which is almost exclusively a capital-importer it may be in the state's interest to offer a different level of protection to foreign investment than it would be for a kleptocratic, developed, capital-exporting state. While the conclusions of this thesis are not addressed to any one specific state, the normative framework provides significant guidance to individual states seeking to determine the level of protection they should offer to foreign investment generally. For example, the analysis of the distributive impacts of differing levels of protection implies that there will be situations in which the economic interests of a predominantly capital-importing and a predominantly capital-exporting state diverge, while the discussion of regulatory chill suggests that it will be particularly important for developing states to consider the consequences of adopting a given level of protection on the functioning of national regulatory authorities. There are several other points at which the normative framework flags the way in which country-specific concerns would feed into the analysis.

That said, the conclusions of this thesis will still be of significant value as a point of departure to states drafting model BITs. As argued in section 1.3.8, there are several reasons why the interests of a single state will tend toward levels of protection that are desirable when assessed from a general perspective. These include the fact that most states are both importers and exporters of capital, at least some extent; that, through IITs, states bind themselves with respect to an uncertain range of regulatory actions that may affect an uncertain set of future investments; and that a model BIT, by its nature, embodies a level of protection that a given state is prepared to offer to differently situated states. Recent consultations on the new US

and EU Model BITs illustrate the importance of general concerns in determining the level of protection that should be provided in a model BIT.[1236]

Special mention should be made of the EU model bilateral investment treaty, which is currently being developed. If this model did become a template for future EU BITs, it would bind all 27 Member States with respect to whichever partner states agree to sign BITs with the EU. Even among the EU Member States there is considerable economic and political diversity; the EU also intends to use the model as the basis for negotiations with partner states with very different political and economic characteristics. On this basis, the drafting of the EU BIT entails a perspective similar to that taken adopted in this thesis, in which the EU must come to a general view about the level of protection that should be provided to foreign investment.

Some states may wish to tailor the level of protection in each BIT to the particular characteristics of the partner state in question. Historically, this practice has been unusual. There are several good reasons why this practice has been unusual, including that the intended effect of providing different levels of protection in different IITs might be circumvented by the structuring of foreign investment, and that it would complicate states' efforts to negotiate and comply with IITs.[1237]

Assuming, *arguendo*, that states wish to determine the level of protection that should be provided in each specific BIT, the conclusions of this thesis would require further development. The normative framework in this thesis would still be a useful point of departure for this analysis. The normative framework already contains a range of disaggregated insights about the extent to which the impacts of a given level of protection are

[1236] Advisory Committee on International Economic Policy (n 40); European Commission (n 40).

[1237] see section 1.3.8.

likely to vary with the characteristics of the state in question. However, it would also be possible to map causal inferences that were specific to the two states in question onto the framework, thereby going beyond the analysis provided in this thesis. For example, it might be possible to come to a more specific view about the likely impact (or lack of impact) of preferring a greater or lesser level of substantive protection in a US-India BIT on the extent to which the Indian bureaucracy conforms to Razian ideals of the rule of law. Such country-specific factors may reinforce the conclusions reached from a general perspective, or they may point to the desirability of a different level of protection in the narrow context of the particular bilateral relationship in question. Nevertheless, the normative framework developed in this thesis, and the more general conclusions derived from it, would remain highly relevant as a point of departure for a country-specific inquiry of this sort.

7.7.1.2 Ideology and the policy preferences of states

International law governing the protection of foreign property was, historically, highly controversial.[1238] The broad spread of IITs that confer remarkably similar levels of substantive protection on foreign investment suggests that much of this fundamental ideological conflict has abated.[1239] Nevertheless, it remains clear that states disagree about the appropriate balance between the 'market', property rights and the regulatory prerogatives of the state.[1240] One of the most important conclusions of this thesis is that, in determining the level of substantive protection that IITs should provide, the objectives of protecting property rights and maximising net economic benefits (stereotypically 'capitalist' concerns) do not necessarily conflict with other objectives of distributive justice, human rights and environmental protection (stereotypically concerns of the New International Economic

[1238] Lowenfeld (n 970) 491-492.

[1239] Schill, *The Multilateralization of International Investment Law* (n 26) 6.

[1240] UNCTAD, *Development Implications* (n 6) 4.

Order).[1241] On this basis, the conclusions of this thesis are offered to all states as a set of insights about the likely consequences of adopting different levels of protection. That said, in some cases it is clear that there is a tension between different objectives. In these situations states may reasonably come to different views about the appropriate balance between competing objectives, views that may well reflect their own policy preferences. For example, a state that is ideologically committed to the inviolability of property rights may sensibly prefer the *Pope & Talbot* approach to indirect expropriation, even though alternative approaches could be expected to entail greater net economic benefits and lead to greater realisation of human rights and environmental protection. On the other hand, neither an ideological commitment to the inviolability of property rights nor a commitment to the economic benefits of free markets can plausibly justify preferring the business plan approach to other, lower levels of protection of investors' legitimate expectations.

7.7.1.3 New protections or redrafting of existing provision

One practical question in translating the preferred level of protection into treaty language is whether to discard existing provisions entirely, or whether to seek to redraft them. The former approach could, for example, involve omitting FET provisions from new IITs and substituting a set of specific provisions that deal with the investor's legitimate expectations, procedural unfairness, substantive irrationality, and other elements of the FET standard that this thesis did not consider, such as the protection against denial of justice. Until now, states have preferred an evolutionary approach, involving the redrafting and clarification of existing provisions.[1242] As the different levels of protection evaluated in this thesis are derived from arbitral interpretations of existing provisions, it makes sense to redraft, rather than replace, those provisions. Linking the preferred approach to a given understanding of an existing

[1241] see UNGA Res 3281 (n 968).

[1242] eg US Model BIT (n 27) art 5.

standard is also likely to provide greater clarity about the intended level of protection to arbitral tribunals.

7.7.1.4 The redrafting of existing provisions to adopt the preferred level of protection

It would be relatively simple to redraft existing provisions so as to adopt a preferred level of protection. Consider, for example, a state that decided to specify that the level of protection provided to an investor's legitimate expectations by a particular IIT was that defined by the legal rights approach. As the protection of legitimate expectations is just one element of the FET standard, as currently understood, the clarifying text would need to be drafted in the negative. One possible formulation is as follows:

> The obligation to provide fair and equitable to foreign investment does not require a state to act consistently with an investor's legitimate expectations, except insofar as those expectations are:
>
> - based on a specific legal right vested in the investor; and
> - legitimate and reasonable in the circumstances, considered in light of normal business risks, regulatory patterns in the industry and any specific representations made by the state to the investor; and
> - relied upon by the investor in making the decision to invest.[1243]

A clause of this sort could be inserted immediately following the statement of the state parties' FET obligation, or it could be incorporated in an interpretative annex to the treaty. The other levels of protection evaluated in this thesis are equally amenable to being translated into treaty language in this way.

7.7.2 Amendment of existing treaties

A second way for states to adopt the desired level of protection is to amend existing IITs. The conclusions of this thesis constitute recommendations that existing IITs be amended, so as to confer the preferred level of protection. The same four issues that arise in the context of

[1243] Derived from restatement of the strict conduct approach, section 5.5.1.3.

drafting new IITs – the different perspective involved in determining the level of protection that should be provided in multilateral investment treaties, model BITs and BITs; the significance of the policy preferences of states; the choice between replacing and redrafting existing provisions; and the practicalities of drafting – all arise in the context of treaty amendment. These issues have been addressed in the previous section. This section considers two additional issues that arise in the context of treaty amendment.

7.7.2.1 The extent of states' power to amend existing treaties

The basic rule defined by article 39 VCLT is that 'A treaty may be amended by the agreement of the parties.'[1244] This formulation places few limits on the form of any 'agreement' to amend a treaty. In the absence of further requirements that a treaty defines for its own amendment, a treaty may be amended 'by an agreement which does not itself constitute a treaty, or by an oral agreement'.[1245] For prudential reasons, states seeking to specify the level of protection provided by existing IITs should do so by agreement in writing.

It has been argued that any distinction between agreements 'amending' an existing treaty and agreements 'interpreting' an existing treaty is only a matter of degree.[1246] For example, in 2002 the Czech and Dutch governments agreed to a 'common position' on certain issues relating to the interpretation and application of the Czech-Netherlands BIT.[1247] At least one commentator has characterised this common position as an amendment,[1248] notwithstanding the fact that it did not purport to modify the treaty. One of the few

[1244] VCLT (n 139).

[1245] Anthony Aust, *Modern Treaty Law and Practice* (Cambridge University Press 2000) 213.

[1246] Roberts (n 167) 201.

[1247] *CME v Czech Republic* Final Award, 14 March 2003 [87]-[93].

[1248] Salacuse (n 32) 350.

differences between ‘interpretations’ and ‘amendments’ is that an agreement that purports to amend an existing treaty will be presumed to operate prospectively.[1249]

7.7.2.2 The impact on the amendment of existing treaties on investors’ rights

An important threshold question is whether IITs confer legal rights on foreign investors. The prevailing view in academic commentary and arbitral awards is that they do.[1250] However, a minority view is that IITs grant substantive legal rights exclusively to states, with foreign investors granted only a procedural right to enforce the substantive rights of their home state through investor-state arbitration.[1251] If this were the case, no issue would arise concerning the impact of amendment of substantive IITs protections on investors’ rights. It is unecessary for this thesis to resolve this debate, and the answer may well depend on the way in which the IIT in question is drafted. The following paragraphs proceed on the assumption that IITs do confer substantive rights on foreign investors and argue that, even if IITs do confer substantive rights on foreign investors, those rights are subject to prospective alteration by agreement between the states that are party to the IIT.

Any discussion about the impact of amendments on investor rights .inevitably takes place in the shadow of academic debate about the legitimacy of the FTC’s binding interpretation of NAFTA art 1105(1).[1252] This interpretation was issued after the *Pope & Talbot* Tribunal’s decision on the merits had been rendered, while the tribunal was determining the damages to be awarded. The *Pope & Talbot* Tribunal was evidently displeased by this intervention and indicated that it perceived the FTC’s statement to

[1249] Roberts (n 167) 201.

[1250] Zachary Douglas, *The International Law of Investment Claims* (Cambridge University Press 2009) [65]; *Corn Products* (n 1152) [165]-[169]; *Cargill v Mexico* ICSID Case No ARB(AF)/05/2, Award, 18 September 2009 [422].

[1251] *Archer Daniel Midlands* (n 1152) [178]-[179].

[1252] Notes of Interpretation art 1105 (n 618).

constitute an 'amendment' rather than an 'interpretation' of art 1105(1).[1253] While this has proved a minority view among tribunals and commentators, it retains some support.[1254] If the statement had constituted an amendment, two legal consequences would have followed: the amendment would not have entered into force, as amendments to NAFTA require ratification to enter into force;[1255] and, even when the amendment did enter into force, it would be presumed to operate prospectively.[1256] For both reasons, characterising the state parties' intervention as an 'amendment' would have entailed the result that the Tribunal was bound to apply the original, unamended provision as the applicable law in the dispute in question.

This controversy should not be understood as casting doubt on the ability of states to prospectively alter the rights conferred on investors by IITs. These rights are created by agreement between states, and they may be withdrawn, terminated or modified in the same way.[1257] Even treaties which grant rights to other states – a situation in which the justification for protecting the reliance interest of the third party beneficiary is significantly more compelling[1258] – may be amended unless 'it is established that the right was intended not to be revocable or subject to modification without the consent of the third State.'[1259] It is clear from the text of articles 36 and 37 VCLT that the central issue in determining whether the parties to a treaty may amend the rights of a third state is the *intention* of the treaty parties.[1260]

[1253] *Pope & Talbot v Canada* Award in Respect of Damages, 31 May 2002 [47].

[1254] Charles H Brower, 'Why the FTC Notes of Interpretation Constitute a Partial Amendment of NAFTA Article 1105' (2006) 46 Virginia Journal of International Law 347, 358.

[1255] NAFTA (n 9) art 2202.

[1256] Roberts (n 167) 201.

[1257] ibid 210.

[1258] cf *Corn Products* (n 1152) [163]-[165].

[1259] VCLT (n 139) art 37(2).

[1260] cf Aust (n 1245) 210.

Assuming, *arguendo*, that states are equally constrained in their ability to alter investors' rights,[1261] it would be necessary to determine whether the parties to an IIT intended the rights of investors to be capable of modification or revocation. This question can only can be answered definitively through a treaty-by-treaty analysis. However, considering the text of typical IITs, it is difficult to infer any intention by the state parties to depart from the normal presumption in favour of the possibility of amendment.[1262] While some IITs do specify that the provisions of the treaty will continue to apply to established investments for a certain period if the treaty is terminated,[1263] such provisions should be understood as provisions to ensure the continued operation of the treaty in the event of termination by one party. They do not evince an intention to limit the treaty parties' powers to agree to amendments that alter the rights of investors.

The implications of the principle of estoppel should also be considered. While the doctrine of estoppel has been recognised as a general principle of international law:[1264]

> ... [I]t is necessary to point out that estoppel in municipal law is regarded with great caution, and the 'principle' has no particular coherence in international law, its incidence and effects not being uniform.[1265]

In cases in which the ICJ has recognised the principle of estoppel, it has been applied to prevent a state from denying the validity of past legal acts previously accepted by the state in question as valid. For example, the ICJ has prevented Nicaragua from denying the validity of

[1261] The European Court of Human Rights appears to accept that 'an established practice within the member States could give rise to an amendment to the Convention' notwithstanding that the European Convention on Human Rights confers rights directly on individuals, *Ocalan v Turkey* (2005) 41 EHRR 985 [163].

[1262] Roberts (n 167) 211.

[1263] Australia-Mexico BIT (n 975) art 24 (3)

[1264] Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (Grotius Publications 1987) 141.

[1265] Brownlie (n 1232) 644.

an arbitral award it previously accepted as valid,[1266] and precluded Thailand for arguing that a treaty with Cambodia, which it had previously accepted as valid, was concluded in error.[1267] Such controversies concerning the legal validity of past acts are distinct from questions concerning limitations on the power of states to amend existing legal rights by future, valid legal acts. The principle of estoppel does not prevent prospective amendment of the rights an IIT confers on an investor, even if the investor has invested on the assumption that a right to a given standard of treatment will subsist for the entire duration of the investment.

7.7.3 Interpretative statements clarifying the meaning of existing IITs – art 31 3 a) VCLT

An alternative to amending existing IITs would be for all the state parties to a given IIT to issue agreed interpretative statements, clarifying that an existing provision of the IIT entails the desired level of protection. All the levels of protection considered in this thesis are based on interpretations of existing IIT provisions by arbitral tribunals. On this basis, it is arguable (but unecessary for this thesis to prove) that each level of protection constitutes a reasonable interpretation of common treaty provisions. While this section argues that it would almost certainly be permissible for states to adopt the preferred level of protection by making joint interpretative statements, it concludes that changes in the extent of investors' rights are best made through amendments, for prudential reasons.

7.7.3.1 The extent of states' explicit and implicit authority to clarify a treaty provision through interpretative statements

Some IITs, such as NAFTA, establish specific procedures that provide for the adoption of interpretative statements setting out the parties joint understanding of the meaning of existing

[1266] *Arbitral Award by the King of Spain (Honduras v Nicaragua)* Judgment of 18 November 1960, ICJ Reports 192, 213.

[1267] *Temple Case (Cambodia v Thailand)* Judgment of 15 June 1962, ICJ Reports 6, 32.

provisions. However, even in the absence of explicit authorisation, there is an abundance of authority for the proposition that, acting jointly, the state parties to a treaty have the authority to interpret it.[1268] Articles 31 and 32 of the VCLT have been accepted as constituting customary international law on the interpretation of treaties.[1269] Article 31 3 a) provides that:

> 3. There shall be taken into account, together with the context:
>
> (*a*) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

The ICJ has given this principle broad application:

> [A]n agreement as to the interpretation of a provision reached after the conclusion of the treaty represents an authentic interpretation by the parties which must be read into the treaty for purposes of its interpretation.[1270]

As with an amendment to a treaty, the form of a subsequent agreement relating to the interpretation of a treaty is unimportant.[1271]

7.7.3.2 The impact of interpretative statements on investors' rights

Following the FTC's interpretative statement, NAFTA tribunals have recognised a wide discretion for states to interpret provisions conferring rights on foreign investors. In response to the argument that the FTC's interpretative statement was illegitimate amendment, the *ADF* Tribunal noted that:

> [W]e have the Parties themselves—all the Parties—speaking to the Tribunal. No more authentic and authoritative source of instruction on what the Parties intended to convey in a particular provision of NAFTA, is possible.[1272]

The Tribunal in *Methanex* expressed a similar view:

[1268] Ian Sinclair, *The Vienna Convention on the Law of Treaties* (2nd edn, Manchester University Press 1984) 136.

[1269] *Avena and other Mexican Nationals (Mexico v United States)* Judgment of 31 March 2004, ICJ Reports 12, 37-38

[1270] *Kasikili/Sedudu Island (Botswana v Namibia)* Judgment of 13 December 1999, ICJ Reports 1045, 1075.

[1271] Richard Gardiner, *Treaty Interpretation* (Oxford University Press 2008) 216.

[1272] *ADF* (n 619) [177].

> If a legislature, having enacted a statute, feels that the courts implementing it have misconstrued the legislature's intention, it is perfectly proper for the legislature to clarify its intention. In a democratic and representative system in which legislation expresses the will of the people, legislative clarification in this sort of case would appear to be obligatory. The Tribunal sees no reason why the same analysis should not apply to international law.[1273]

The fact that such interpretative statements may have the effect, in practice, of modifying the extent of investors' rights under NAFTA does not seem to have caused either Tribunal particular concern.

Roberts has examined in detail the question of whether there are any limits to states' discretion to alter the scope of investors' rights through the exercise of interpretative authority. She identifies two important dimensions to states' exercise of interpretative authority. The first is whether the agreed interpretation is a 'reasonable' interpretation of the provision in question; the second is the timing of the interpretation. She argues that states are only constrained from adopting binding interpretations that are both unreasonable and late (in the sense of being adopted after a claim has been brought).[1274] Even in extreme situations involving unreasonable and late interpretative agreement, the legal basis of the constraint on the powers of states to interpret the instrument that they have created is unclear. The constraint Roberts identifies seems to have its origins in prudential concerns about preserving 'the credibility of investment treaty commitments'[1275] and a legal realist assumption that tribunals will be inclined to resist such blatant interventions in the adjudicatory process by finding some justification to refuse to give effect to them.[1276] Arguably, some constraint is also implied by the structure of Article 31 of the VCLT, in which a 'subsequent agreement ...

[1273] *Methanex* (n 470) pt IV ch C [22].

[1274] Roberts (n 167) 213

[1275] ibid.

[1276] ibid 214.

regarding the interpretation of the treaty' is only one, albeit a highly significant, element that must be considered in the interpretative exercise.

For the purpose of this thesis it is unnecessary to define the outer limit on states' authority to define the level of protection provided by IITs through interpretative statements. Throughout this thesis, the case for adopting given levels of protection in IITs has been made on the basis that the preferred rule would be adopted prospectively. As Roberts argues, there are strong prudential grounds to avoid altering investors' rights retrospectively and even more compelling grounds to avoid creating the impression of interfering in the adjudication claims that have been already been brought. It is for these reasons that this thesis concludes that any agreement between states about the level of protection provided by IITs is better presented as a prospective 'amendment' clarifying the level of protection provided by IITs than as a retrospective 'interpretation'.[1277]

7.8 General conclusions II – contributions of this thesis to normative debate

7.8.1 Challenging the 'market' vs 'state' dichotomy

A number of more general conclusions that are relevant to existing academic and policy debates emerge from the analysis. Perhaps the most important of these relates to the framing of academic debate about the level of protection that IITs should provide to foreign investment as a conflict between 'free market' and 'statist' ideologies. In the existing scholarly literature, the protection of foreign investment through IITs is often understood as justified by the economic benefits of the 'free market', while imposing sovereignty costs on host states.[1278] This view is also implicit in commentary that frames the central issue in academic and policy debate about IIT protections as involving the balancing of investors'

[1277] cf van Aaken, 'Between Commitment and Flexibility' (n 242) 536.

[1278] Sornorajah (n 56) 186; cf Vandevelde, 'Political Economy of a BIT' (n 59) 622.

rights and states' regulatory autonomy.[1279] Market versus state discourse has always been conceptually unstable – it is as easy to construe the granting of legal protection to foreign investment as *interference* in the operation of markets as to construe it as a measure necessary to perfect the institutional underpinnings of markets. Nevertheless, the market versus state dichotomy has proved remarkably resilient. One of the most significant contributions of this thesis is to require this way of framing normative debate to be reconsidered.

This thesis has argued that, even when taken on their own terms, 'economic' arguments do not provide unconditional justification for IIT protections. Through a detailed engagement with economic argument, it has shown that broader IIT protections cannot be assumed to create net economic benefits and that in many situations broader investment protection can be expected to entail significant net economic costs. Through a close assessment of existing empirical evidence it has cast considerable doubt on the assumption that broader IIT protections would entail greater FDI flows. The implications of these arguments are traced through the debate about the level of protection that IITs should provide. For example, this chapter has argued that the business plan approach to the legitimate expectations element of the FET standard is likely to be less efficient and no better at encouraging FDI flows than the permissive conduct approach.

It follows that 'economic' objectives – efficiency and the attraction of FDI – are not fundamentally in tension with 'non-economic' objectives; tension between the two may arise in certain situations but not in others.[1280] The implications of this conclusion are traced through the debate about the level of protection that IITs should provide. For example, this

[1279] Kingsbury and Schill (n 192) 103; Mann (n 20) 5; Spears (n 126) 1042.

[1280] see Christopher McCrudden, *Buying Social Justice* (Oxford University Press 2007) 577, reaching a similar conclusion in the context of international regulation of public procurement.

chapter has argued that the *Pope & Talbot* approach to indirect expropriation is likely to entail greater net economic benefits and be associated with greater realisation of human rights and environmental conservation than the *Metalclad* approach.

7.8.2 General conclusions relating to the level of protection that should be provided by IITs

This thesis offers four general conclusions that are relevant to existing academic debate about the level of protection that IITs should provide to foreign investment. The first concerns the distinction between the impact of government conduct on the legal entitlements of an investor and the impact of conduct on the economic value of the investment. Insofar as liability turns on an assessment of the impact of a state's conduct on the investor's interests, IIT protections that focus on interference with legal entitlements are likely to be preferable to protections that focus on loss of economic value. For example, the comparison of the strict conduct approach and the legal rights approach to legitimate expectations raised doubts about the desirability of protecting the expectations of foreign investors that have no basis in the legal system of the host state, even when such expectations rest on specific unilateral representations made by the host state. There are far more serious concerns about the wisdom of levels of protection such as the business plan approach and the *Metalclad* approach, in which loss of economic value of an investment is sufficient to trigger a state's liability without any additional requirement of breach of a unilateral representation.

A second conclusion concerns the impact of various levels of protection on the degree of respect for the rule of law. While the argument that IIT protections promote respect for the rule of law is one of the most common justifications for the existence of IITs, the analysis in the preceding sections showed that determining the impact of IIT protections on respect for the Razian understanding of that concept is exceedingly complex. Levels of protection that impose more demanding obligations relating to the conduct of domestic administration on

host states are not necessarily associated with improvements in respecting the rule of law, as argued in the comparison of the intermediate and exacting approaches to the procedural element of the FET standard.

A third conclusion concerns the desirability of arbitral deference to policy judgements made by host states. Public law critiques of IITs tend to argue that protections that entail greater deference to domestic policy judgements would be desirable. The comparison of margin-of-appreciation and politics-as-irrationality approaches suggest that deference to a host state's choice of policy objectives is likely to be highly desirable so far as substantive review of the rationality of government conduct is concerned. However, determining the appropriate degree of deference to policy choices that entail interference with foreign investors' legal entitlements raises far more challenging normative questions, which normally involve the balancing of competing norms. In such situations greater deference to host states is not, self-evidently, more desirable.

A fourth conclusion is that lower levels of protection are likely, in general, to be more desirable than higher levels of protection. This chapter has argued that the legal rights approach and the margin-of-appreciation approach are, respectively, the most desirable level of protection of foreign investors' legitimate expectations and level of protection from substantive irrationality. It may well be that still narrower protections would be more desirable than the narrowest level of protection derived from existing jurisprudence. That said, narrower protections are not, self-evidently, more desirable. This chapter has argued that the intermediate approach to protection from procedural unfairness is more desirable than the narrow approach. Moreover, in the case of different levels of protection implied by arbitral decisions interpreting indirect expropriation provisions, it is not always possible to say which of two qualitatively different levels of protections is 'narrower'.

7.8.3 Defining an agenda for future research

In identifying the limitations and gaps in existing evidence about the consequences of IIT protections, the framework developed in Chapater 4 also helps define an agenda for future empirical research. There is particular need for research exploring the extent to which states internalise IIT protections at various levels of government. Little is known about the impact of IIT protections on government decisions-making, save in the small minority of cases that result in public disputes between investors and states. A useful starting point for such research would be the examination of attempts by states to institutionalise compliance with IITs. A sophisticated case study methodology would be required, including interviews with both government lawyers and with regulators and policy-makers who lack legal knowledge. These case studies could then be compared to studies of states that have no formal procedures to institutionalise IIT compliance. Such research would contribute to understanding of questions about the impact of IIT protections on the efficiency of government conduct, respect for the rule of law, and the realisation of human rights and environment conservation.

Another useful subject for future empirical research concerns the impact of IIT protections on investors' behaviour. To generate useful insights, such a project would need a broad and representative sample of foreign investors. Such a research project could explore the extent to which investors themselves, and their legal advisors, were aware of IITs. It would also be important to consider the extent to which investors' understood the scope of legal protection provided by IITs. It would be useful to know if IITs were considered at the project decision stage, the project structuring stage, or only after a dispute had arisen with the host state. It would be important to determine whether this tended to vary according to home state, host state and industry. It would be valuable to more about how investors perceive IITs in comparison to other legal and non-legal techniques for reducing project risks. Such

research would contribute to understanding of the impact of IIT protections on the efficiency of investor conduct and FDI flows.

7.9 Reflections on the normative framework

This section reflects on the normative framework developed in this thesis, in light of the experience of its application. The purpose of this discussion is to acknowledge limitations of the framework and difficulties in its application. Despite these limitations and difficulties, this section argues that the normative framework remains a useful way to frame normative debate about the level of substantive protection provided to foreign investment by IITs. This section is divided into four sections: the first concerns the inherent uncertainty involved in making predictions about the future; the second concerns the potential for disagreement about the normative criteria by which the likely consequences of IIT protections should be judged; the third concerns the range of different options available in redrafting IITs; and the fourth section concludes the thesis.

7.9.1 The limitations of existing evidence and the inherent uncertainty of inferences about the future

The most significant limitations of the normative framework concern the empirical basis for inferences about the consequences of adopting different legal rules. There are, in fact, two distinct concerns. The first relates to fundamental uncertainty about the consequences of future actions; the second relates to the question of whether the explanatory theories and empirical evidence examined in Chapter 4 provide a sufficient foundation for the inferences drawn from them.

The first limitation is less telling than it first appears. The consequences of future actions are always uncertain, yet choices must be made. States continue to negotiate and sign IITs, and on each a occasion a choice is made, consciously or unconsciously, about the

appropriate level of substantive protection to provide to foreign investment. Any option chosen will reflect certain causal assumptions. Indeed, Chapter 2 has shown that existing normative debate is populated by a range of assumptions, often implicit and seldom the subject of sustained examination, about the likely consequences of providing protection to foreign investment. The central epistemological question is not whether causal inferences should be made – thinking about policy choices inevitably entails causal assumptions – the central question is which causal inferences are justified and on what basis they should be drawn. Given the role that causal inferences play in normative debate, this thesis seeks to ground inferences about the likely consequences of adopting different levels of protection in more secure conceptual and evidentiary foundations than are offered in the existing literature.

The second limitation relates to the robustness of the particular inferences drawn. This thesis' approach to deriving probabilistic inferences from theory and evidence is grounded in the tradition of the New Haven school of law and economics. Moreover, the approach adopted in this thesis attempts to address some of the criticisms of this approach by testing the assumptions and predictions of theoretical arguments against empirical evidence. Other approaches might have been adopted, such as deriving inferences inductively from a set of case studies. This would also be a legitimate approach that could yield many useful insights. However, as section 4.2 has argued, it would be subject to significant limitations of its own – notably, the difficulty in deriving generalisable insights about the likely conduct of actors under a proposed level of protection from observations of the behaviour of particular actors under IITs as they currently exist. This process of abstraction would *necessarily* involve the specification of some theoretical model.

Ultimately, the robustness of the inferences drawn depends both on the validity of the theoretical models and the strength of the evidentiary basis on which they rely. Chapter 4 provides a defence of the theoretical models used to predict the likely consequences of

various legal rules, a rigorous assessment of existing evidence to the extent it exists, and an honest reflection about the limitations of the models invoked and of gaps in existing evidence. The analysis justifies a set of probabilistic inferences presented with varying degrees of certainty. None of these causal inferences are asserted as a priori truths that are valid independently of the theoretical assumptions and empirical evidence on which they rest.

Academic understanding of the consequences of legal rules is constantly evolving, both through critiques of existing theoretical models and through the examination of new evidence as it comes to light. The framework presented in this thesis should be subject to continuing review in light of new evidence that may confirm or cast doubt on the particular inferences drawn. (Indeed, one of the important contributions of this thesis is to define an agenda for future research.) If any of the levels of protection considered in this thesis were actually adopted by states, it would be important to consider the extent to which their impact was consistent with the predictions derived from Chapter 4. In the meantime, the inferences drawn in this thesis constitute a robust and informed contribution to an ongoing academic and policy debate. I submit that the causal inferences drawn in this thesis provide a significantly more robust account of the likely consequences of adopting different levels of IIT protection than is available elsewhere in the existing literature.

7.9.2 Disagreement about normative premises and the normative framework

This thesis has argued, in Chapter 2, that there is a relatively high degree of consensus in the existing literature that the normative criteria articulated by the framework are desirable. It argued that the choice of these particular norms was justified and coherent, a choice that also framed the way in which the likely consequences of adopting different levels of IIT protection were categorised and understood. Nevertheless, there remain legitimate grounds for disagreement about the normative criteria by which different levels of protection should be evaluated.

Two particular objections might be made to the choice of normative criteria. The first is that the set of criteria is under or over-inclusive; for example, the argument that FDI flows do not have intrinsic normative value and should be omitted from the framework, or the argument that the framework should explicitly include the principle of sustainable development. The second objection is that the framework should have been based on different understandings of included criteria, for example, that it should have been based on a different conception of the rule of law to that proposed by Raz. The normative framework is not intended to foreclose future debate about the criteria by which different levels of protection should be evaluated. Rather, it purports to show the value in being transparent and specific about the premises that underpin normative argument. The framework could be adapted if a consensus emerged that a particular criterion should be discarded, added or amended. (This observation confirms the flexibility of the analytical approach taken in this thesis; it is not intended to imply any lack of confidence in the particular criteria that constitute the normative framework, the choice of which was carefully justified.)

7.9.3 The range of different options available in redrafting IIT protections

This thesis has evaluated a range of differing levels of protection derived from interpretations of existing IIT provisions. However, there is a broader range of options available to states in redrafting IIT protections, including the abandonment of existing provisions, the invention of entirely new provisions, and the tying of existing levels of protection to doctrines of national law. These options could be adopted individually or in some combination. This thesis does not intend to foreclose debate about the desirability of levels of protection that are not evaluated in this thesis. Rather, due to the length constraints of the doctoral format and to the constraints of practicality, this thesis has articulated a set of plausible options, each of which is defined with sufficient specificity to be the subject of the normative inquiry. This evaluation of different levels of protection derived from existing jurisprudence is offered as

an important and relevant contribution to existing academic and policy debate. It also generated more general conclusions. The normative framework in this thesis could also be used to evaluate other levels of protection, if they were proposed elsewhere.

7.9.4 Conclusion: a normative framework to improve, not foreclose, debate

Much of the existing debate about IIT protections is based on causal assumptions, often implicit, that are subject to little critical reflection. This is equally true of assumptions made by proponents of IITs about the impact of granting substantive protection to foreign investment on FDI flows as it is of assumptions made by critics about the extent of regulatory chilling of government measures. The normative framework developed in Chapter 4 provides a rigorous assessment of explanatory theory and empirical evidence relating to the consequences of IIT protections. This assessment provides a more solid foundation for inferences about the likely consequences of adopting differing levels of IIT protection. The framework also offers a precise and transparent articulation of the normative criteria by which inferred consequences should be evaluated. It clarifies the bounds of disagreement, as well as the extent of underlying agreement, about various normative claims. In bringing more rigour to the assessment of causal assumptions and more clarity to the specification of normative criteria, this framework can improve the quality of ongoing normative debate about the level of substantive protection that IITs should provide to foreign investment.

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