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Jonathan Bonnitcha
*University of New South Wales*

Emma Aisbett
*Australian National University*

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# AGAINST BALANCING: REVISITING THE USE/REGULATION DISTINCTION TO REFORM LIABILITY AND COMPENSATION UNDER INVESTMENT TREATIES

*Jonathan Bonnitcha and Emma Aisbett**

## I. INTRODUCTION

A network of over three thousand treaties governs international investment. These investment treaties share remarkable similarities in their structure and core provisions.[1] They provide foreign investments with a suite of legal protections from adverse conduct by "host" states in which they invest.[2] If a foreign investor believes that the host state has breached these

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* Jonathan Bonnitcha is a Senior Lecturer in law at the University of New South Wales and Emma Aisbett is a Fellow at the School of Regulation and Global Governance (RegNet) and Associate Director, Research for the Grand Challenge - Zero Carbon Energy for the Asia Pacific at the Australian National University. Our thanks to Sarah Brewin, Tomer Broude, David Gaukrodger, Caroline Henckels, Jarrod Hepburn, Anthea Roberts and Esme Shirlow for helpful discussions and comments on a draft of this paper. Participants in the Society of International Economic Law Biennial Conference (Washington, D.C., July 2018), a workshop hosted by the University of New South Wales Herbert Smith Freehills Law and Economics Initiative (Sydney, Dec. 2018) and a workshop hosted by the Australian National University's School of Regulation and Global Governance (Canberra, Apr. 2019) provided helpful comments and suggestions on earlier versions of the draft. Thanks to Alisha Mathew for excellent research assistance. The University of New South Wales Herbert Smith Freehills Law and Economics Initiative also provided generous financial assistance with the costs of publication. Finally, we are grateful to the editors at the *Michigan Journal of International Law* for their assistance in bringing this article to publication, notwithstanding the challenges of a global pandemic.

1. *See generally* RUDOLF DOLZER & CHRISTOPH SCHREUER, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW (2d ed. 2012); JONATHAN BONNITCHA, LAUGE N. SKOVGAARD POULSEN & MICHAEL WAIBEL, THE POLITICAL ECONOMY OF THE INVESTMENT TREATY REGIME (2017). Consistently with the existing literature, our definition of 'investment treaty' includes bilateral investment treaties, plurilateral investment treaties, see, for example, Energy Charter Treaty, Dec. 17, 1994, 34 I.L.M 360, and the investment chapters of multi-issue free trade agreements. *See, e.g.,* Comprehensive and Progressive Agreement for Trans-Pacific Partnership, ch. 9, Mar. 8, 2018 [hereinafter CPTPP], https://www.dfat.gov.au/trade/agreements/in-force/cptpp/Pages/comprehensive-and-progressive-agreement-for-trans-pacific-partnership.

2. A growing minority of investment treaties also include provisions that require host states to remove restrictions/limitations on incoming foreign investment—i.e. investment liberalization provisions. In this article, we do not address issues raised by these provisions. For consideration of some of the issues raised by the interaction between investment protection and investment liberalization provisions, *see* Emma Aisbett, Larry Karp & Carol McAusland,

treaty protections, it can bring a claim against that state to international arbitration. This mechanism for adjudication of claims under investment treaties is popularly known as investor-state dispute settlement ("ISDS"). If the investor is successful, the arbitral tribunal will require the host state to compensate the investor. These awards of compensation can be enforced internationally through associated regimes for the recognition and enforcement of arbitral awards.[3]

Once an obscure corner of international law familiar to only a handful of specialists, investment treaties are now among the most controversial instruments of international economic governance. States, including the architects of the existing regime, are now reconsidering their participation in such treaties.[4] Two related features of investment treaties have proven particularly controversial. First, critics contend that investment treaties allow foreign investors to challenge legitimate and justifiable regulatory changes.[5] Philip Morris' challenge to the introduction of tobacco plain packaging in

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*Compensation for Regulatory Taking in International Investment Agreements: Implications of National Treatment and Rights to Invest*, 1 J. GLOB. & DEV. 1–3 (2010).

3. *See, e.g.*, Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, art. 1, *opened for signature* Mar. 18, 1965, 17 U.S.T. 1270; 575 U.N.T.S. 159 (entered into force Oct. 14, 1966); Convention on the Recognition and Enforcement of Arbitral Awards, *opened for signature* Jun. 10, 1958, 3 U.S.T. 2517, 330 U.N.T.S. 38 (1958).

4. U.S. Trade Representative Robert Lighthizer, for example, has criticized investor-state dispute settlement ("ISDS") provisions in investment treaties. *See In His Own Words: Lighthizer Lets Loose on Business, Hill Opposition to ISDS, Sunset Clause*, INSIDE U.S. TRADE (Oct. 19, 2017), https://insidetrade.com/trade/his-own-words-lighthizer-lets-loose-business-hill-opposition-isds-sunset-clause. The transition from the North American Free Trade Agreement ("NAFTA") to the United States-Mexico-Canada Agreement ("USMCA") has since removed the U.S.-Canada investment relationship from the coverage of ISDS. *Compare* North American Free Trade Agreement, Dec. 17, 1992, 107 Stat. 2057, 32 I.L.M. 289, *with United States of America, the United Mexican States and Canada Agreement*, Off. U.S. Trade Representative (July 1, 2020) [hereinafter USMCA], https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between. In May 2020, twenty-three European Union ("EU") Member States signed a treaty to terminate intra-EU bilateral investment treaties. *EU Member States Sign an Agreement for the Termination of Intra-EU Bilateral Investment Treaties*, EUR. COMM'N (May 5, 2020), https://ec.europa.eu/info/files/200505-bilateral-investment-treaties-agreement_en. However, the EU continues to pursue investment treaties with other states. More generally, there is currently a multilateral process underway within United Nations Commission on International Trade Law ("UNCITRAL") Working Group III for the reform of the investment treaty regime. *See infra* Part VI. *See generally Status of Preparatory Work on Reform Options and Schedule of Events—Working Group III: Investor-State Dispute Settlement Reform*, U.N. COMM'N ON INT'L TRADE L. (May 14, 2020), https://uncitral.un.org/en/working_groups/3/investor-state.

5. *See, e.g.*, Anthea Roberts, *Triangular Treaties: The Extent and Limits of Investment Treaty Rights*, 56 HARV. INT'L. L.J. 353, 379 (2015); Lorenzo Cotula, *Do Investment Treaties Unduly Constrain Regulatory Space?* 9 QUESTIONS INT'L. L. 19, 19–20 (2014); David Gaukrodger, *The Balance Between Investor Protection and the Right to Regulate in Investment Treaties: A Scoping Paper* (Org. for Econ. Coop. & Dev. ("OECD") Working Papers on Int'l Inv. No. 2, 2017).

Australia and Vattenfall's challenge to the phase-out of nuclear power generation in Germany are high profile examples. Second, critics contend that outsized awards of compensation place too great a burden on public finances, particularly in developing countries.[6] For example, in the recent case of *Tethyan Copper v. Pakistan*, Pakistan was required to pay $5.9 billion U.S. Dollars to a Canadian mining company for failing to issue a mining lease required for the development of a planned copper mine to go ahead.[7] Although the mine was never built, compensation in that case was based on the mine's projected income over its entire fifty-year operating cycle if it had been allowed to go ahead. This award of compensation was almost as large as the bailout that Pakistan and the International Monetary Fund ("IMF") had negotiated two months earlier to save the Pakistani economy from collapse.[8]

Many states have responded to the first of these concerns through revisions to their treaty practice.[9] To date, however, revisions to investment treaties' substantive provisions have been largely reactive and incremental, in the sense that they seek to exclude particularly controversial provisions, or interpretations of provisions, found in earlier generations of treaties.[10] These changes have not been linked to any underlying account of the economic rationale for granting internationalized legal protections to foreign investment, or to any assessment of investment treaties' effectiveness in

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6. A 2018 UNCTAD study found that the average amount of compensation awarded was $504 million U.S. Dollars ("USD"), although the median award was significantly lower at $20 million U.S. Dollars ("USD"), reflecting the impact of several very large awards on the average. *See generally* U.N. CONF. ON TRADE & DEV., WORLD INVESTMENT REPORT 95 (2018). For a more recent compilation of all award over $100 million USD, see JONATHAN BONNITCHA & SARAH BREWIN, INT'L INST. FOR SUSTAINABLE DEV., COMPENSATION UNDER INVESTMENT TREATIES 1, 29–31 (2019).

7. Jeffrey Sachs, *How World Bank Arbitrators Mugged Pakistan*, PROJECT SYNDICATE (Nov. 26, 2019), https://www.project-syndicate.org/commentary/world-bank-corrupt-arbitration-ruling-against-pakistan-by-jeffrey-d-sachs-2019-11.

8. The bailout, negotiated in May 2019, was reported as providing a $6 billion USD in funds to Pakistan. *See* Salman Masood, *Pakistan to Accept $6 Billion Bailout from I.M.F.*, N.Y. TIMES (May 12, 2019), https://www.nytimes.com/2019/05/12/world/asia/pakistan-imf-bailout.html.

9. *See generally* REASSERTION OF CONTROL OVER THE INVESTMENT TREATY REGIME (Andreas Kulick ed., 2016).

10. For example, the carve-out of tobacco control measures from the scope of ISDS under the CPTPP. *See* CPTPP, *supra* note 1. Another example is the European Union's clarification of the fair and equitable treatment standard in article 8.10(2) of the Comprehensive Economic and Trade Agreement between Canada and the European Union and its Member States. *See generally EU-Canada: Comprehensive Economic Trade Agreement*, EUR. COMM'N [hereinafter CETA], http://ec.europa.eu/trade/policy/in-focus/ceta/ as discussed in Caroline Henckels, *Protecting Regulatory Autonomy Through Greater Precision in Investment Treaties: The TPP, CETA, and TTIP*, 19 J. INT'L ECON. L. 27, 35–40 (2016). For a more systematic analysis of these dynamics, see Wolfgang Alschner, *The Impact of Investment Arbitration on Investment Treaty Design: Myth Versus Reality*, 42 YALE J. INT'L L. 1, 35–36 (2016).

achieving their policy objectives. Surprisingly little attention has been given to the second of these concerns—that is, the principles governing compensation under investment treaties.[11]

In this context, we pose the following two questions in a companion paper:[12]

i. In what circumstances should an investment treaty require a host state to pay compensation for interference with foreign investment?
ii. In such circumstances, how much compensation should be required?

Although legal scholars tend to deal with these questions separately, we show that they are intimately connected and should be dealt with together. Using the tools of law and economics, we show that investment treaties are likely to generate mutual benefits for host states and foreign investors to the extent that they discipline opportunistic conduct by host states. We argue that investment treaties should not constrain state's ability to respond to new information or to change their policy priorities. Our specific proposal is that a state should only have to compensate the investor if it breaches or modifies the domestic legal regime governing the investment, and that compensation should be the lesser of the investor's loss and the host state's gain from the host's state not having had the new legal regime in place when the investment was made.[13]

Key practical implications of our proposal are that states should not be required to compensate investors in many of the circumstances that are compensable under existing investment treaty jurisprudence and that, insofar as compensation is required, the amount of compensation will ordinarily be less than is currently the case. Another distinguishing feature of our proposal is that it does not require arbitral tribunals to weigh or balance competing interests in order to determine whether compensation is required or, insofar as compensation is required, to determine the amount that should be paid. This is a sharp break with existing investment treaty jurisprudence, which relies heavily on balancing as a mode of arbitral reasoning,[14] and also

11. *Cf.* Diane A. Desierto, *The Outer Limits of Adequate Reparations for Breaches of Non-Expropriation Investment Treaty Provisions: Choice and Proportionality in Chorzów*, 55 COLUM. J. TRANSNAT'L L. 395 (2017); Steven Ratner, *Compensation for Expropriations in a World of Investment Treaties: Beyond the Lawful/Unlawful Distinction*, 111 AM. J. INT. L. 7, 20–21 (2017).

12. Emma Aisbett & Jonathan Bonnitcha, *A Pareto-Improving Compensation Rule for Investment Treaties* 24 J. INT'L ECON. L. 181 (2021).

13. This proposal draws on a set of concepts—notably, the concept of "the domestic legal regime"—that are defined precisely in our companion paper. In Part II of this paper, we recall the definitions of these concepts. In Part IV, we show how these concepts could be operationalized in investment arbitration as a practical matter.

14. *See infra* Part IV.

a point of contrast with other prominent proposals for reform.[15] The title of this article reflects this feature of our proposal.[16]

In this article, we situate our proposal in relation to existing academic debates, explore its implications in practice and consider additional policy arguments for our proposal beyond the criterion of Pareto improvement deployed in our companion paper.[17] The article is organized as follows. Part II provides an overview of the rationale for our proposal, as set out in our companion paper. It also recalls the definitions of key concepts from our companion paper and, in doing so, clarifies the series of questions a tribunal would have to answer to apply our approach in practice.

Having briefly revisited the arguments of our companion paper in Part II, Parts III-VI comprise the original contribution of this article. Part III situates our proposal within long-standing academic debates about the extent to which private property should be protected from adverse government action. We show that legal scholarship on the protection of private property from government interference can be divided into two broad traditions. The first tradition maintains that, to determine whether government interference with property requires compensation, a court or tribunal should balance the investor's interests against countervailing public interests that might justify the interference. The second tradition posits that a court or tribunal should distinguish government "use" (or appropriation) of property from government regulation of property, with only the former requiring compensation. According to this tradition, the capacity in which the government is acting, rather than weighing and balancing competing interests, determines a distinction between the use and regulation of private property. Our proposal falls squarely within this second tradition. However, scholarship within this tradition faces challenges of its own—notably, the difficulty in distinguishing between government "use" and "regulation" of property in complex cases.

Part IV explains how our proposal relates to the rules and principles governing liability and compensation under existing investment treaties. We use a series of well-known cases as examples to illustrate the implications.

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15. *See, e.g.*, VALENTINA VADI, PROPORTIONALITY, REASONABLENESS AND STANDARDS OF REVIEW IN INTERNATIONAL INVESTMENT LAW AND ARBITRATION 263–65 (2018) (arguing for a more careful calibration of existing balancing techniques).

16. To be clear, we are contrasting our proposal to alternatives in which arbitral tribunals are required to engage in balancing as a mode of reasoning in order to come to a decision in the case before them. The concept of balance might also be understood in a different, wider sense. Because legal regimes impact upon different interests, changes to the design of any legal regime might be said to have implications for the balance that regime strikes between interests. Our proposal does not obviate the need to consider how investment treaties affect diverse interests in this sense; indeed, our companion paper makes a sustained argument for why our proposal should be preferred on this basis. We are grateful to David Gaukrodger for encouraging us to clarify this point.

17. Aisbett & Bonnitcha, *supra* note 12, at 3 (discussing Pareto improvement and defining it as occurring when at least one party is left better off and no party is left worse off).

In the course of this exposition, we show that our proposal builds on concepts and approaches that have been implemented in other legal regimes. For example, our approach to compensation is similar to the calculation of compensation based on restitution and reliance in contract law. In pointing to these similarities, we seek to pre-empt concerns that our proposal involves too radical a shift from current jurisprudence. By combining these familiar concepts in a new way, we argue that our proposal resolves many practical challenges with both the status quo and with previous attempts to develop a workable jurisprudence based on the use/regulation distinction.

Part V develops the analysis of our companion paper by considering additional political economy and democratic arguments for our proposal. The model in our companion paper was based on the assumption that all organs of the host state fully and accurately internalize the welfare of all affected domestic constituencies in their decision-making. This is a common simplifying assumption in the law and economics literature but it is not necessarily empirically accurate.[18] We show that our proposal is robust to variation in this assumption. Second, we consider the risk of more serious pathologies in government decision-making, such as susceptibility to lobbying and capture by foreign investors. We argue that our proposal is also preferable to the status quo when these risks are taken into account. Third, and perhaps most importantly, we argue that there are strong democratic arguments for preferring our proposal to the status quo.

Part VI connects our proposal to the multilateral discussions about reform of the investor-state dispute settlement system currently underway in United Nations Commission on International Trade Law ("UNCITRAL") Working Group III. Reform of the principles governing compensation under investment treaties is a key negotiating priority for developing countries. In October 2019, the issue of the principles governing compensation was added to the agenda of Working Group.[19]

## II. OUR PROPOSAL: BASIC RATIONALE AND KEY CONCEPTS

In this section we set out the basic rationale for our proposal, as developed in our companion paper. We then explain the key conceptual building blocks on which our proposal rests. In doing so, we clarify the series of questions a tribunal would need to ask, and answer, in applying our approach.

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18. For example, Aisbett and Poulsen's analysis of World Bank data survey data suggests that host states treat foreign firms no worse, on average, than comparable domestic firms. *See, e.g.*, Emma Aisbett & Lauge Skovgaard Poulsen, *Relative Treatment of Aliens: Firm-level Evidence from Developing Countries* 1 (Glob. Econ. Governance Programme Working Paper No. 122, 2016).

19. Comm'n on Int'l Trade L., Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-Eighth Session, ¶¶ 102–104, U.N. Doc. A/CN.9/1004 (July 6–17, 2020).

## A. *Rationale for Our Proposal*

The argument for our proposal rests on three central claims. First, we argue that investment treaties should be designed to ensure that becoming and remaining party to a treaty benefits each state party.[20] If investment treaties did not increase welfare of all state parties to them, disadvantaged states would have no reason to voluntarily become or remain parties to such treaties, and the regime would prove unstable in the medium to long term.[21] Indeed, one of the reasons for the instability we are presently seeing in the current regime is that many developing countries have real doubts about whether continuing to participate in investment treaties is in their interests.[22] This first claim has significant implications for our analysis. Bilateral investment treaties were historically negotiated between developed and developing countries, and many investment treaties continue to govern bilateral relationships in which investment flows are highly asymmetric.[23] In practi-

20. Our approach is consistent with the view of some scholars. *See, e.g.*, James R. Markusen, *Commitment to Rules on Investment: The Developing Countries' Stake* 9 R. INT'L ECON. 287, 292–293, 300–01 (2001); Jan Kleinheisterkamp, *Investment Treaty Law and the Fear for Sovereignty: Transnational Challenges and Solutions*, 78 MOD. L. REV. 793, 793, 810 (2015). It contrasts with the view of other scholars, who argue that investment treaties should be evaluated from an aggregate global welfare perspective, regardless of whether some states are left worse off. *See, e.g.*, José E. Alvarez, *The Once and Future Foreign Investment Regime*, *in* LOOKING TO THE FUTURE: ESSAYS ON INTERNATIONAL LAW IN HONOR OF MICHAEL REISMAN 634, 635 (Mahnoush Arsanjani, Jacob Katz Cogan, Robert Sloane & Siegfried Wiessner eds., 2011); Roberts, *supra* note 5, at 378–80.

21. In the law and economics literature this is termed states' "participation constraint." *See* Anne van Aaken, *International Investment Law Between Commitment and Flexibility: A Contract Theory Analysis*, 12 J. INT'L ECON. L. 507, 515 (2009). There is ample evidence that states are already questioning their participation in the investment treaty regime.

22. Poulsen and Aisbett show that the rate at which developing states enter into new investment treaties slows markedly following their first experience as respondent in an investment treaty arbitration. *See* Lauge Poulsen & Emma Aisbett, *When the Claim Hits: Bilateral Investment Treaties and Bounded Rational Learning* 65 WORLD POL. 273, 286 (2013). Some developing states, such as South Africa and India, have gone further and terminated existing investment treaties. *See* Fabio Morosini & Michelle Ratton Sanchez Badin, *An Introduction, in* RECONCEPTUALIZING INTERNATIONAL INVESTMENT LAW FROM THE GLOBAL SOUTH 4, 19–21 (Fabio Morosini & Michelle Ratton Sanchez Badin eds., 2018).

23. The world's largest bilateral investment relationships are between pairs of developed countries and are characterized by significant flows of investment in both directions. Most such investment relationships are *not* covered by investment treaties. For example, only one of Germany's ten largest bilateral investment relationships is covered by an investment treaty. Following the entry into force of the United States-Mexico-Canada Agreement, only one of the United States' largest ten investment relationships is covered by an investment treaty and that coverage (of the U.S.-Mexico relationship) is partial. Notwithstanding some notable exceptions, the majority of the world's investment treaties are bilateral treaties that govern the relationship between a developed and a developing country. Jonathan Bonnitcha, Lauge Poulsen & Jason Yackee, *A Future Without (Treaty-Based) ISDS: Costs and Benefits*, *in* INTERNATIONAL ECONOMIC DISPUTE SETTLEMENT: DEMISE OR TRANSFORMATION? (Manfred Elsig, Rodrigo Polanco & Peter van den Bossche eds., forthcoming 2021).

cal terms, this means that such treaties are only justified if they benefit state parties that are predominantly host states.

Second, we elucidate that investment treaties, as they are currently drafted, address two conceptually distinct economic problems. The first is time inconsistency of the host state's optimal policy toward the investment —a host state at least theoretically has an incentive to offer attractive conditions to new foreign investment and then renege on the bargain once the investment has been made. An example is a state that grants a foreign investor a concession to build and operate a mine and then seizes possession of the mine once construction is complete. The second is a broader problem that the host state may undervalue foreign investors' interests when responding to new information throughout the life cycle of the investment. New information, as we understand it, encompasses a diverse range of changing circumstances, including new knowledge about an investment's impacts, changes in commodity prices and underlying shifts in citizens' political preferences.[24] All these events may encourage a state to change the way it regulates foreign investment in ways that look superficially similar to conduct driven by time inconsistency. Yet, such cases differ conceptually from situations of time inconsistency. In "pure" cases of new information, the host state does not benefit from inducing the investment and then changing the regulatory arrangements governing it. An example is a state that gives a foreign investor permission to commence the construction of a mine and then shuts the project down, citing its unacceptable environmental impacts. The state has gained nothing by allowing and then cancelling this investment.

Complications arise because problems of time inconsistency and new information are intertwined in common fact scenarios. Consider, for example, the situation in which a host state *sells* a foreign investor a concession to build and operate a mine and, subsequently, cancels the concession, citing unacceptable environmental impacts arising from the mine's operation. One of the major contributions of our companion paper is the development of a mathematical model that formalizes and clarifies the relationship between problems of time inconsistency and new information and shows how the two problems can be intertwined in a variety of complex fact scenarios.

Third, we show that solving problems of time inconsistency benefits both home and host states by encouraging foreign investors to proceed with mutually beneficial investment projects. In contrast, investment treaties that constrain states' discretion to respond to new information can leave host states worse off, overall. While such treaties may encourage additional investment, our companion paper shows that, for several common factual scenarios, any benefit of such additional investment is outweighed by the risk

24. *See* van Aaken, *supra* note 21, at 517; Henrik Horn & Thomas Tangeårs, *Economics and Politics of International Investment Agreements* (Rsch. Inst. for Indus. Econ., IFN Working Paper No. 1140, 2016).

the host state assumes in agreeing to indemnify investors for actions taken in response to new information.

On this basis, we argue that investment treaties should be designed and interpreted to provide the minimum protection to foreign investment necessary to solve time inconsistency problems for the host state. Using the tools of law and economics, we develop a proposal that is capable of fully solving problems of time inconsistency without constraining states' ability to respond to new information. We propose that a state should only have to compensate the investor if it breaches or modifies the domestic legal regime governing the investment and that compensation should be the lesser of the investor's loss and the host state's gain from the host state not having had the new legal regime in place when the investment was made. We show that our proposal increases both host and home state welfare across a diverse array of fact scenarios compared to a counter-factual where there is no investment treaty.

### B. *Key Concepts: Explaining Our Proposal*

To understand how our proposal would operate in practice, and how it compares to existing jurisprudence, it is necessary to recall the definitions of our conceptual building blocks, which are set out in the companion paper. The first of these is our concept of "the domestic legal regime." We use this concept to capture the terms on which a host state allows foreign investment to take place in its territory. Our conception of the "domestic legal regime" is broad; it does not depend on the designation of the instruments involved under the law of the host state, so long as they create binding rights and obligations. As such, the domestic legal regime is a composite concept that includes the provisions of any contract negotiated between the foreign investor and the host, as well as the powers of the host state to tax and regulate the investment under laws in force at the time the investment is made. The investment's operating licenses—including any pre-specified taxes, charges, or royalty payments—also comprise part of the host state's domestic legal regime. The domestic legal regime, as it relates to an investment, would ordinarily cover issues such as the permissible uses of land and other assets, mandatory regulatory requirements, and tax, royalty, and pricing arrangements. Our conception of the domestic legal regime does not, however, include expectations or plans a foreign investor may have (or may claim to have) unless those expectations are grounded in the law of the host state. In Part IV we will see that this is a significant point of difference with existing investment treaties, which have been interpreted to protect an investor's legitimate expectations, without requiring that those expectations be grounded in legal entitlements.[25]

25. For a typology of legitimate expectations, see Michele Potestà, *Legitimate Expectations in Investment Treaty Law: Understanding the Roots and Limits of a Controversial Concept*, 28 ICSID REV., 88, 100–19 (2013); *see also* JONATHAN BONNITCHA, SUBSTANTIVE

Because the rationale of our proposal is to solve problems of time inconsistency for the host state, some breach or change of the domestic legal regime that was in place when the investment was made is a necessary condition for compensation to be required. But it is not a sufficient condition. If this threshold condition is met, our proposal then requires a tribunal to consider the situation that would have existed if the new domestic legal regime —or, in cases in which the host has breached rather than changed its own laws, a domestic legal regime that permitted such breaches—were already in place before the investment was originally made. This involves an exercise in counter-factual reasoning. Existing principles governing compensation under investment treaties also require tribunals to engage in counter-factual reasoning, but the relevant counter-factual under existing jurisprudence is different: the situation that would have existed *but for* the host state's conduct of which the investor complains.

Compensation, under our proposal, is the lesser of the investor's loss and the host state's gain compared to the situation that would have existed if the new domestic legal regime was in place before the investment was originally made. In many situations, it will be uncontroversial that one or other of these amounts is zero, in which case no compensation is required and no further analysis is needed. For example, consider a host state's unilateral reduction to contractually agreed tariffs paid to an investment in the utility sector. Such a change will inevitability reduce the investment's profitability. But, if the investor would have made its investment anyway, even if the reduced tariff rates had been in place from the outset, it has not suffered a loss that is compensable under our proposal. Notwithstanding the host state's unilateral action, in this situation, the investor is still better off than if it had not invested and, therefore, has not suffered any loss as a result of its reliance on the original contractually agreed tariffs.

In other scenarios the relevant gain to the host state will be zero, and no further inquiry is needed. The case of a state that shuts down a mine due to its environmental impacts is an example. Absent some additional factor, such as payments by the investor to the state or the construction of dual-use infrastructure that is subsequently repurposed by the state, a state gains nothing by allowing and then cancelling an investment. In this way, our proposal distinguishes between loss arising from regulatory change, which is a risk that investors should be required to bear, and the seizure of an investor's assets by a state, which is compensable.

In situations where neither figure is zero, our proposal requires some compensation. A more complex valuation exercise is then needed to determine the amount of compensation. Nevertheless, calculation of compensation under our proposal is still likely to be simpler than calculation of compensation under existing jurisprudence. The evidence required to determine

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PROTECTION UNDER INVESTMENT TREATIES: A LEGAL AND ECONOMIC ANALYSIS 169 (2014).

compensation under our proposal will include documentation of amounts the investor has actually paid to the state in order to obtain permits and concessions, costs actually incurred by the investor in making the investment, valuation of any assets or resources transferred into state ownership during the lifespan of the investment, and income earned by the investor up to the date of the dispute. Note that the evidence required to calculate compensation under our proposal relates largely to actual events in the past for which reliable evidence is normally available. In contrast, existing jurisprudence requires a tribunal to make and justify a complex set of interlocking forecasts about the *future* financial situation the investor would have been in but for the host state's breach of the investment treaty. We return to these practical benefits of our proposal as compared to the status quo in Part IV.

## III. THE EMERGENCE AND DEVELOPMENT OF THE USE/REGULATION DISTINCTION

Our proposal builds on a line of a scholarship that has grappled with a similar intuition to that which animates our proposal—that government seizure of private property differs from government regulation of private property, and that compensation should be paid only in the case of the former. Foundational contributions to this literature have focused on the protection of private property from government "taking" under the U.S. Constitution.[26] The national constitutional context differs from an investment treaty context in certain respects. In particular, all costs and benefits associated with constitutional protection of private property are presumptively internal to the state in question, which means that our application of the Pareto criterion would not necessarily play out in the same way in a constitutional context.[27] Nevertheless, debates about the protection of private property under the U.S. Constitution remain an important point of reference, both because key provisions of investment treaties are a codification of U.S. constitutional doctrine,[28] and because other influential scholars in the field take these debates as their starting point for an analysis of investment treaties.[29] In this section we trace the development of the use/regulation distinction as an al-

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26. The fifth amendment to the U.S. Constitution provides "nor shall private property be taken for public use without just compensation." U.S. CONST. amend. V.

27. Institutional considerations in the United States also differ somewhat from international investment law. *See, e.g.*, WILLIAM A FISCHEL, REGULATORY TAKINGS: LAW, ECONOMICS, AND POLITICS (1995). Fischel's account of takings jurisprudence turns largely on differences in the decision-making between local government and national government. The relationship between our proposal and institutional considerations that are specific to the investment treaty regime is considered *infra* Part V.

28. *See infra* Section IV.A.

29. Susan Rose-Ackerman & Jim Rossi, *Disentangling Deregulatory Takings*, 86 VA. L. REV. 1435, 1469 (2000); Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, 78 N.Y.U. L. REV. 30, 78 (2003).

ternative to balancing techniques. We also draw attention to some significant challenges that have complicated attempts to build a coherent jurisprudence on the use/regulation distinction.

In the mid-twentieth century, U.S. constitutional jurisprudence on the protection of private property was widely regarded as inconsistent and lacking any underlying theoretical justification. At the time, there were three mutually inconsistent threads in jurisprudence, each with its own problems.[30] The first approach required compensation whenever government action entailed physical possession or occupation of private property.[31] But the application of this principle led to bizarre results—notably that trivial incursions into physical property would require compensation, while severe interference with intangible property rights would be non-compensable.[32] The second approach required compensation when government action sought to secure some public benefit but not when it aimed to prevent a harm.[33] But this test suffered from indeterminacy. Prevention of almost any harm can be reframed as creation of a public benefit—for example, prevention of pollution could be understood as promoting a clean environment.[34] The third approach required compensation whenever government action led to a significant diminution of the value of private property.[35] But this test suffered from indeterminacy of a different sort. If a government expropriated ten acres of land from a 100 acre bloc, should this be understood as a minor diminution in the value of the 100 acre bloc, or a complete destruction of the value of the expropriated portion?[36] The third test also cut against lawyers and policy-makers' intuitions about the contours of a fair takings jurisprudence, in

30. *See* Joseph L. Sax, *Takings and the Police Power,* 74 YALE L.J. 36, 37 (1964); Jed Rubenfeld, *Usings*, 102 YALE L.J. 1077, 1088 (1993); Been & Beauvais, *supra* note 29, at 59–61.

31. Sax, *supra* note 30, at 46; Rubenfeld, *supra* note 30, at 1083 (citing Pumpelly v. Green Bay Co., 80 U.S. 166 (1871) and Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) as examples).

32. Sax, *supra* note 30, at 46–47.

33. Sax, *supra* note 30, at 48; Rubenfeld, *supra* note 30, at 1085 (citing Mugler v. Kansas*,* 123 U.S. 623 (1887)).

34. Glynn S. Lunney Jr., *Responsibility, Causation, and the Harm-Benefit Line in Takings Jurisprudence*, 6 FORDHAM ENV'T L.J. 433, 435 (1995); Lucas v. S.C. Coastal Council*,* 505 U.S. 1003 (1992).

35. Sax, *supra* note 30, at 50; Rubenfeld *supra* note 30, at 1086–87 (citing Pa. Coal Co. v. Mahon*,* 260 U.S. 393 (1992)).

36. "The underlying conceptual problem is that, 'to the extent that any portion of property is taken, that portion is always taken in its entirety.' " Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Plan. Agency, 535 U.S. 302, 331 (2002) (citing Concrete Pipe & Prods. of Cal., Inc. v. Constr. Laborers Pension Tr. for S. Cal., 508 U.S. 602, 644 (1993)). For discussion of this problem in an investment treaty context, see Vaughan Lowe, *Changing Dimensions of International Investment Law* 62–64 (Oxford Legal Studs. Rsch. Paper No. 4, 2007); SANTIAGO MONTT, STATE LIABILITY IN INVESTMENT TREATY ARBITRATION: GLOBAL CONSTITUTIONAL AND ADMINISTRATIVE LAW IN THE BIT GENERATION 268 (2009); BONNITCHA, *supra* note 25, at 236–37.

that it would require compensation in situations where a property owner complains of otherwise-lawful government action that the owner knew was likely to occur when it acquired the property in question.

Modern legal scholarship takes these problems with mid-twentieth century jurisprudence as its starting point. In response, two general approaches to reformulation were proposed in the academic literature. The first argued that determining whether government interference with private property requires compensation inevitably involves weighing and balancing of a range of competing factors and sought to provide a framework to guide such exercises in balancing. In an influential 1967 article, Frank Michelman argued that determining the appropriate level of protection of private property required the weighing of all the private and social costs involved.[37] In the *Penn Central* decision, the U.S. Supreme Court adopted a version of Michelman's proposal, noting that the following factors would need to be balanced: "The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment backed expectations are, of course, relevant considerations. So, too, is the character of the governmental action."[38]

Other frameworks for organizing balancing inquiries were influential elsewhere. For example, in resolving claims of the violation of the right to property, the European Court of Human Rights mandates a balancing inquiry organized around the concept of proportionality.[39] Scholars such as Robert Alexy have subsequently explored and clarified the conceptual foundations of proportionality as an organizing principle for a structured balancing inquiry.[40]

A second response to the problems with takings jurisprudence was to suggest that a distinction could be drawn between different types of government conduct. In a seminal article in the *Yale Law Journal*, Joseph Sax proposed a "distinction between the role of government as participant and the government as mediator in the process of competition among competing

37. Michelman argued that a full accounting of costs and benefits could be organized under the headings of "efficiency gains," "demoralization costs," and "settlement costs." Frank Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 60 HARV. L. REV. 1165, 1214 (1967). Michelman's framework has been heavily criticized, including by other proponents of balancing. *See, e.g.*, Robert Cooter, *Unity in Tort, Contract and Property: The Model of Precaution*, 73 CALIF. L. REV. 1, 21–22 (1985).

38. Penn Central Transp. Co v. City of New York, 438 U.S. 104, 124 (1978).

39. Tom Allen, *Compensation for Property Under the European Convention on Human Rights*, 28 MICH. J. INT'L L. 287, 294 (2007)*; see also* Yves Winisdoerffer, *Margin of Appreciation and Article 1 of Protocol No 1*, 19 HUM. RTS. L.J. 18, 19 (1998). For an example of the methodology see Sporrong v. Sweden, 5 Eur. Ct. H.R. Rep. 21, ¶ 73 (1982).

40. ROBERT ALEXY, A THEORY OF CONSTITUTIONAL RIGHTS 66–67 (Julian Rivers trans., 2002); *see also*, KAI MÖLLER, THE GLOBAL MODEL OF CONSTITUTIONAL RIGHTS 13–15 (Oxford Univ. Press 2012); AHARON BARAK, PROPORTIONALITY: CONSTITUTIONAL RIGHTS AND THEIR LIMITATIONS 3–4 (Cambridge Univ. Press 2012).

economics [interests].”[41] He argued that compensation should be required whenever government acts in the former *enterprise* capacity, but not when it acts in the latter capacity as a *mediator* between competing private interests. The application of this distinction leads to different results than balancing tests. Under Sax’s approach, compensation will always be required when the government acquires resources from a private actor—for example, pencils for use in government agencies—even when the value of the resources acquired is low and there is clear public interest justification for their acquisition. In contrast, it suggests that regulatory action—for example, pollution control legislation—should not be compensable, even when that action is unexpected and leads to severe economic loss for specific private actors.

Sax’s argument was based on a theory that government acting in its enterprise capacity has incentives to interfere with private property for the benefit of the state itself, which are absent when government acts as a mediator.[42] Subsequent scholars further developed Sax’s argument, arguing that protecting private property from government acting in its capacity as a mediator is unlikely to improve government conduct, even if one assumes that governments are prone to mediate between interests in ways that are unfair and arbitrary. For example, Susan Rose-Ackerman and Jim Rossi argue that imposing legal obligations on government to pay compensation for interference with private property is unlikely to redress government dysfunction in mediating between private interests because the burden of compensation ultimately falls on taxpayers, rather than government decision-makers themselves.[43] Vicki Been and Joel C. Beauvais put forward that extending legal protection to private property from action taken by the government in its capacity as mediator fails to redress a dysfunctional government’s hypothesized indifference to the *benefits* that regulatory actions create for various constituencies, leading to excessive caution on the part of government.[44] These arguments strengthen the case for focusing constitutional protection of private property exclusively on disciplining government action in its enterprise capacity. We return to their relevance for the drafting of investment treaties in Part V.

Although Sax’s proposal was not adopted in U.S. law, his ideas are reflected in jurisprudence elsewhere. Under Australian constitutional jurisprudence, for example, government interference with private property is only compensable if it constitutes an *acquisition* of that property.[45] Under Canadian statutory protections of private property, compensation is only required for regulatory action if there has been an appropriation of a property interest

41. Sax, *supra* note 30, at 62.

42. Sax, *supra* note 30, at 61–64.

43. Rose-Ackerman & Rossi, *supra* note 29, at 1482.

44. Been & Beauvais, *supra* note 29, at 96–100.

45. *Georgiadis v Australian & Overseas Telecomms Corp* (1994) 179 CLR 297 (Austl.).

by the state itself.[46] These examples are important, in that they show that a jurisprudence organized around the distinction between government action in its enterprise and in its mediator capacity represents a genuine, practical alternative approach to a jurisprudence organized around the balancing of competing interests.

We share the intuition that animates Sax's account. However, his argument was not based on any underlying economic analysis of the problem of time inconsistency, which led to several difficulties. First, it assumed that the distinction between government acting in an *enterprise* capacity and in a *mediator* capacity was self-evident, without proposing a means for drawing the line between the two categories.[47] Subsequent scholars recognized this challenge, but still continued to assume that cases could be classified as involving government acting in either one or other capacity.[48] Second, Sax's approach seemed to suggest that any increase in tax rates should be fully compensable, a conclusion which he rightly regarded as untenable.[49]

In a 1993 article, Jed Rubenfeld sought to address the former problem by recasting the distinction as one between government "use" and "regulation" of private property, with only the former requiring compensation.[50] To distinguish between government use and government regulation of property, he proposed that interference with private property would not amount to a compensable use if the state's interest would be "equally well served by destroying that thing altogether." But Rubenfeld's approach creates anomalies, particularly when applied to intangible property.[51] His approach would re-

46. Bryan P Schwartz & Melanie R Bueckert, *Regulatory Takings in Canada*, 5 WASH. UNIV. GLOB. STUDS. L. REV. 477, 488 (2006); Matthew C. Porterfield, *State Practice and the (Purported) Obligation Under Customary International Law to Provide Compensation for Regulatory Expropriations*, 37 N.C. J. INT'L L. & COM. REG. 159, 179 (2011); Andrew Newcombe, *The Boundaries of Regulatory Expropriation in International Law*, 20 ICSID REV. 1, 8–9 (2005).

47. Sax's most precise statement of his rule is as follows:

> When an individual or limited group in society sustains a detriment to legally acquired existing economic values as a consequence of government activity which enhances the economic value of some government enterprise, then the act is a taking, and compensation is constitutionally required; but when the challenged act is an improvement of the public condition through resolution of conflict within the private sector of the society, compensation is not constitutionally required.

Sax, *supra* note 30, at 67. This rule turns on the concept of "government enterprise," which is illustrated with examples but never defined.

48. Rose-Ackerman & Rossi, *supra* note 29, at 1478. Other scholars have argued that this challenge proves that recourse to balancing techniques is inevitable. *See* MONTT, *supra* note 36, at 191–98, 237–42.

49. Sax, *supra* note 30, at 75–76.

50. Rubenfeld, *supra* note 30, at 1116.

51. Rubenfeld rejected the consequentialist approach of law and economics. Rubenfeld, *supra* note 30, at 1131–34. Yet, engaging more deeply with the insights of law and economics

quire compensation if the government sells public land to an investor and then renationalizes the land the following day, but not if the government sells an investor a concession to operate a mobile phone network on a designated spectrum and then cancels the concession the following day, having pocketed the sale price.[52] Been and Beauvais's argument that investment treaties should constrain only physical seizure or assumption of control of foreign investment suffers from the same problem.[53]

In an important 2009 article on the drafting and interpretation of investment treaties, Anne van Aaken puts the use/regulation distinction on a firmer conceptual footing by drawing attention to the underlying distinction between government conduct that is opportunistic and government conduct that responds to new information.[54] She argues that government conduct should only be compensable if it is opportunistic. We agree. But van Aaken left three significant challenges posed by the insight unaddressed. First, she assumes that state conduct can be classified as *either* opportunistic *or* as responding to new information. Second, discussion of the principles governing compensation under investment treaties is not integrated into her analysis, notwithstanding that the consequences of breach are essential to economic analysis of the *ex ante* effects of legal rules. Third, her approach requires tribunals to determine, after the fact, whether impugned conduct was a response to information that was genuinely "new."[55] She rightly recognized that this task poses immense practical difficulties.[56] In the following section, we show how our proposal addresses and resolves all three challenges.

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might have encouraged him to develop an approach that treated functionally similar cases similarly, regardless of their formal designation.

52. Such cases have proved consistently difficult for courts in countries, such as Australia and Canada, where constitutional protection of private property turns on whether there has been an *acquisition* or *appropriation* of private property. *See, e.g.*, *Newcrest Mining (WA) Ltd v Commonwealth* (1997) 190 CLR 514 (Austl.); Newcombe, *supra* note 46, at 46. Newcombe's proposed solution is that compensation should be required when state conduct annuls or otherwise destroys "contractual commitment or authorization upon which an investor relied." However, this solution would require compensation in cases where state conduct that would otherwise be classified as "regulatory" interferes with contractual rights. It would also lead to an anomaly in that contractual rights would benefit from greater legal protection than rights of ownership in relation to physical property. To date, doctrines developed by such courts to address the issue have been *ad hoc* and unconvincing. *See, e.g.*, *ICM Agric Pty v Commonwealth* (2009) 240 CLR 140, ¶ 149 (Austl.).

53. Been & Beauvais, *supra* note 29, at 142.

54. van Aaken, *supra* note 21, at 517–19.

55. *Id.* at 526.

56. *Id.* at 526.

## IV. Reconceptualizing Substantive Protection and Principles Governing Compensation

In this section we examine how our proposal compares to existing jurisprudence under investment treaties. We begin with a brief review of investment treaties as they are currently drafted and interpreted. We show that the application of core investment treaty protections requires tribunals to engage in the balancing of competing interests. If the host state is found to have breached one of these protections, compensation equals the loss the investor has suffered compared to a future counter-factual in which the host state has not breached the treaty. Having clarified the status quo, we examine how our proposal differs, using case examples to illustrate. This exercise also demonstrates that our proposal is feasible, in that it relies on information and legal techniques that are available and familiar to arbitral tribunals. Finally, we show how our proposal resolves many of the practical challenges associated with both the status quo and with plausible alternatives, including the three challenges associated with previous attempts to operationalize the use/regulation distinction that we identified in Part III.

### A. *The Status Quo: Investment Treaties as Currently Drafted and Interpreted*

#### 1. Substantive Protection: *"*Balancing*"* as a Mode of Reasoning

As currently drafted, investment treaties grant a common suite of legal protections to foreign investment. These include guarantees of compensation for expropriation, fair and equitable treatment, and compliance with contractual obligations that the host state has incurred in relation to the investment. These core standards are sometimes described as "absolute" protections, in the sense that the extent of the host state's obligations does not depend on how domestic investment is treated.[57]

Investment treaties also contain "relative" provisions guaranteeing nondiscriminatory treatment to foreign investment, as well as provisions that guarantee minimum standards of due process in adjudicative proceedings within the host state's legal system.[58] Such provisions are much less likely

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57. Catherine Yannaca-Small, *Fair and Equitable Treatment Standard in International Investment Law* 2 (OECD Working Papers on Int'l Inv. No. 3, 2004).

58. One complication is that the general obligation to provide fair and equitable treatment ("FET") to foreign investment is normally understood to incorporate a minimum guarantee of due process in adjudicative proceedings as one of the constituent "elements" of the general obligation. For example, USMCA, *supra* note 4, art. 14.6(2)(a) reads "fair and equitable treatment includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world." This treaty language is widely understood to incorporate the customary international law doctrine of denial of justice into the FET standard. However, in practice, few claims that a state has breached the FET standard turn on an allegation of denial

to constitute the basis for ISDS claims against host states.[59] While our proposal may also have implications for the reform of treaty provisions dealing with discrimination and due process,[60] in this section we focus on its implications for reform of investment treaties' core absolute standards, which give rise to the majority of investment treaty disputes. These guarantees are normally drafted in vague language, the meaning and implications of which has been established through interpretation and application by arbitral tribunals.

The most important substantive protection contained in investment treaties is the guarantee of fair and equitable treatment ("FET"). This provision is both the clause that foreign investors invoke most frequently in arbitration and the one with which they have the highest rate of success.[61] Tribunals' interpretations of FET provisions are not entirely consistent. Tribunals have held, variously, that FET provisions protect investors from conduct that is unreasonable, disproportionate, or inconsistent with investors' legitimate

of justice. For detailed discussion of the doctrine of denial of justice, see JAN PAULSSON, DENIAL OF JUSTICE IN INTERNATIONAL LAW (2005).

59. For example, UNCTAD statistics show that breach of an investment treaty's FET provision has been alleged in 449 cases; breach of an investment treaty's indirect expropriation provision has been alleged in 412 cases; and breach of an umbrella clause has been alleged in 143 cases. In contrast, breach of national treatment provisions has been alleged in only 134 cases, and only nine such claims have been successful. *See Investment Dispute Settlement Navigator*, U.N. CONF. ON TRADE & DEV., https://investmentpolicy.unctad.org/investment-dispute-settlement (last visited May 27, 2020).

60. In principle, our proposal is capable of subsuming investment treaties' guarantees of due process and non-discriminatory treatment. With respect to due process, the logic of our proposal is that investment treaties should function as devices that allow states to credibly commit to observing whatever level of procedural fairness that state has chosen to offer to foreign investment as a matter of law. With respect to non-discriminatory treatment, the logic of our proposal is that there should not be any freestanding prohibition on discriminatory treatment. Discriminatory treatment would *sometimes* require compensation under our rule, but only to the extent the host state's conduct was opportunistic and therefore captured by the normal operation of our rule. In this way, our proposal would avoid many of the conceptual challenges facing existing jurisprudence on *de facto* discrimination - notably, the challenge in determining whether any difference in the burden of complying with a government measure between investors is justified by the host state's policy objective. For discussion of these conceptual challenges, see ANDREW D. MITCHELL, DAVID HEATON & CAROLINE HENCKELS, NON-DISCRIMINATION AND THE ROLE OF REGULATORY PURPOSE IN INTERNATIONAL TRADE AND INVESTMENT LAW 141 (2016) (citing AES Summit Generation Ltd. v. Republic of Hung., ICSID Case No. ARB/07/22, Award, ¶ 10.3.9 (Sept. 23, 2010), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C114/DC1730_En.pdf). While noting these implications of our proposal, we also note that there are arguments in support of existing guarantees of due process and non-discriminatory treatment beyond those that we consider in this paper. For this reason, we do not take a position on whether these more radical reforms of investment treaties would be desirable.

61. *Investment Dispute Settlement Navigator*, *supra* note 59; BONNITCHA ET AL., *supra* note 1.

expectations.[62] Notwithstanding differences between the various "elements" of the FET standard, these doctrines all require tribunals to balance the harm state conduct causes to the foreign investor against other policy justifications for the state's action.[63] In this sense, they all require tribunals to adopt the same mode of reasoning.

Balancing as a mode of reasoning is most explicit in decisions evaluating the proportionality of state conduct under FET provisions. For example, in emphasizing that host states retain relatively broad discretion to regulate foreign investment, the tribunal in *Electrabel v. Hungary* explained that the boundaries of that discretion were to be charted through the balancing of competing interests:

> [T]he Tribunal considers that the application of the [Energy Charter Treaty's] FET standard allows for a balancing exercise by the host State in appropriate circumstances. The host State is not required to elevate unconditionally the interests of the foreign investor above all other considerations in every circumstance. As was decided by the tribunals in *Saluka v Czech Republic* and *Arif v Moldova*, an FET standard may legitimately involve a balancing or weighing exercise by the host State. . . .
>
> . . . ["T]here 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." In the Tribunal's view, this includes the requirement that the impact of the measure on the investor be proportional to the

62. The challenges of providing an internally consistent account of existing FET jurisprudence have been explored in detail in the academic literature. These challenges are reflected by the fact that, while almost all commentators agree that it is useful to divide FET jurisprudence into decisions dealing with different "elements" of the standard, no two text writers propose an identical system of classification. *See* ANDREW PAUL NEWCOMBE & LLUIS PARADELL, LAW AND PRACTICE OF INVESTMENT TREATIES 275 (2009); DOLZER & SCHREUER, *supra* note 1, at 145; IOANA TUDOR, THE FAIR AND EQUITABLE TREATMENT STANDARD IN THE INTERNATIONAL LAW OF FOREIGN INVESTMENT 154 (2008); JESWALD SALACUSE, THE LAW OF INVESTMENT TREATIES 218 (2010); KENNETH J. VANDEVELDE, BILATERAL INVESTMENT TREATIES 190, 234 (2010); CAMPBELL MCLACHLAN, LAURENCE SHORE & MATTHEW WEINIGER, INTERNATIONAL INVESTMENT ARBITRATION: SUBSTANTIVE PRINCIPLES 226 (2007); RONALD KLÄGER, 'FAIR AND EQUITABLE TREATMENT' IN INTERNATIONAL INVESTMENT LAW 117–18 (2011); BONNITCHA, *supra* note 25, at 163.

63. Academic scholarship recognizes that arbitral decisions applying the FET standard engage in balancing. *See*, *e.g.*, Benedict Kingsbury & Stephan W. Schill, *Public Law Concepts to Balance Investors' Rights with State Regulatory Actions in the Public Interest—the Concept of Proportionality*, *in* INTERNATIONAL INVESTMENT LAW AND COMPARATIVE PUBLIC LAW 75 (Stephan W. Schill ed., 2010); CAROLINE HENCKELS, PROPORTIONALITY AND DEFENCE IN INVESTOR-STATE ARBITRATION (James Crawford & John S. Bell eds., 2015); David Gaukrodger, *Addressing the Balance of Interests in Investment Treaties: The Limitation of Fair and Equitable Treatment Provisions to the Minimum Standard of Treatment Under Customary International Law* (OECD Working Papers on Int'l Inv. No. 3, 2017).

> policy objective sought. The relevance of the proportionality of the measure has been increasingly addressed by investment tribunals and other international tribunals, including the ECtHR. The test for proportionality has been developed from certain municipal administrative laws, and requires the measure to be suitable to achieve a legitimate policy objective, necessary for that objective, and not excessive considering the relative weight of each interest involved.[64]

Subsequent decisions have endorsed these statements in principle, while applying such balancing tests in a way that is arguably more favorable to the investor. For example, in *Novenergia v. Spain*, the tribunal held that "the assessment of whether the FET standard has been breached is a balancing exercise, where the state's regulatory interests are weighed against the investors' legitimate expectations and reliance."[65]

Balancing also underpins the influential doctrine of legitimate expectations. For example, in *Duke Energy v. Ecuador*, the tribunal explained that FET standard protects expectations derived from "conditions that the State offered the investor" at the time an investment was made. To determine whether an expectation is legitimate—i.e. whether its violation triggers the liability of the host state—a tribunal "must 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."[66] To assess whether the host state breached the investor's legitimate expectations, tribunals routinely weigh the investor's interest in the stability of government policy against the state's regulatory objectives.[67] The tribunal in *Oostergetel v. Slovakia* summarized the doctrine simply, in the following terms: "legitimate expectations must be measured through a balancing test taking account of specific circumstances."[68]

Other common substantive protections found in investment treaties require tribunals to engage in balancing as a mode of reasoning. Many recent investment treaties explicitly instruct tribunals to engage in a balancing ex-

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64. Electrabel S.A. v. Republic of Hung., ICSID Case No. ARB/07/19, Award, ¶¶ 165, 179 (Nov. 25, 2015), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C111/DC7353_En.pdf.

65. Novenergia II—Energy and Env't (SCA) (Grand Duchy of Lux.), SICAR v. Kingdom of Spain, Arb. Inst. of the Stockholm Chamber of Com. [SCC] Case No. 2015/063, Final Arbitral Award, 30 World Trade & Arb. Materials 947, ¶ 694 (2018).

66. Duke Energy Electroquil Partners v. Republic of Ecuador, ICSID Case No. ARB/04/19, Award, ¶ 340 (Aug. 18, 2008), 20 World Trade & Arb. Materials 189 (Dec. 2008).

67. *See, e.g.,* Saluka Invs. BV (The Neth.) v. The Czech Republic, Partial Award, 18 World Trade & Arb. Materials 169, ¶ 306 (UNCITRAL, June 2006); Total S.A. v. Argentine Republic, ICSID Case No. ARB/04/01, Decision on Liability, ¶ 309 (Dec. 27, 2010), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C30/DC7833_En.pdf.

68. Oostergetel v. The Slovak Republic, Final Award, ¶ 224 (UNCITRAL, 2012), https://www.italaw.com/sites/default/files/case-documents/ita0933.pdf.

ercise to determine whether a compensable indirect expropriation has occurred. For example, treaties based on the 2004 U.S. Model Bilateral Investment Treaty ("BIT") contains the following clarification of the concept of indirect expropriation, which is based on U.S. Supreme Court's *Penn Central* decision:

> 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 inquiry 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
> >
> > (iii) the character of the government action.[69]

Tribunals and commentators have understood this clarification as requiring a particular form of structured balancing inquiry: one that weighs the measure's adverse impact on the investment and the extent to which the investor had relied on the legal regime that existed prior to the measure against potential justifications for the measure.[70] Similar clarifications have disseminated widely beyond U.S. treaty practice, and are now found in the Association of Southeast Asian Nations Comprehensive Investment Agreement, the Canada-European Union Trade Agreement, and the China-Japan-Korea Investment Treaty, among others.[71] Even in cases where the relevant investment treaty does not explicitly clarify the meaning of indirect expropriation,

69. Off. of the U.S. Trade Representative [USTR], U.S. Model Bilateral Investment Treaty, Annex B (2004).

70. *See* Glamis Gold, Ltd. v. United States, Final Award, 48 I.L.M. 1038, ¶ 356 (UNCITRAL, 2009); Bear Creek Mining Corp. v. Republic of Peru, ICSID Case No. ARB/14 /21, Award, ¶ 377 (Nov. 30, 2017), 30 World Trade & Arb. Materials 5 (2018); L. Yves Fortier (CC, QC) & Stephen L. Drymer, *Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor*, 13 ASIA PAC. L. REV., 79, 100 (2005); Rachel Esdall, *Indirect Expropriation Under NAFTA and DR-CAFTA: Potential Inconsistencies in the Treatment of State Public Welfare Regulations*, 86 B.U. L. REV. 931, 957 (2006); BONNITCHA, *supra* note 25, at 263–70.

71. *See* Association of Southeast Asian Nations Comprehensive Investment Agreement, annex II, Feb. 26, 2008, https://asean.org/asean-economic-community/asean-investment-area-aia-council; CETA, *supra* note 10, annex VIII; Protocol to the Investment Promotion and Protection Agreement between Japan, Republic of Korea, and China art. 2, May 13, 2012, https://www.mofa.go.jp/announce/announce/2012/5/pdfs/0513_01_01.pdf.

tribunals have used balancing techniques to determine whether a compensable indirect expropriation has occurred.[72]

The key conclusion that emerges from the foregoing review of existing jurisprudence is that, to determine whether the host state has breached common substantive protections in investment treaties, arbitral tribunals frequently balance the interests of the investor against those of the host state. It is important to attach some caveats to this conclusion. First, we recognize that there are diverse legal techniques to balance competing interests. Often the choice of one technique over another will be decisive in a particular case.[73] For example, in *Philip Morris v. Uruguay*, the dissenting arbitrator argued that the FET provision placed a more demanding burden of justification on the host state than that accepted by the majority.[74] On this basis, the dissenting arbitrator would have found that Uruguay had breached the investment treaty. Second, we recognize that not all disputes under investment treaties require a tribunal to engage in balancing. For example, tribunals have resolved claims under umbrella clauses by determining the host state had breached an underlying investment contract. This requires the tribunal to apply the law governing the underlying contract, normally the law of the host state itself.[75] Our claim is not that tribunals engage in balancing in *every* investment treaty dispute, but rather that the majority of investment treaty disputes across a range of common treaty provisions require tribunals to engage in some form of balancing of competing interests.[76] This conclusion is important, as one of the key features of our proposal is that it does *not* require tribunals to engage in balancing.

### 2. Prospective, Loss-Based Compensation

Investment treaties, as they are currently drafted, only explicitly address the amount of compensation due in the event of an expropriation. The basic principle, contained in almost every investment treaty, is that compensation

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72. *See, e.g.*, Técnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award (May 29, 2003), 43 I.L.M. 133 (2004); LG&E Energy Corp. v. Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability, ¶ 189 (Oct. 3, 2006), 46 I.L.M. 36 (2006); PL Holdings S.à.r.l. v. Republic of Poland, SCC Case No. V2014/163, Partial Award, ¶ 355 (2017), https://www.italaw.com/sites/default/files/case-documents/italaw9378.pdf.

73. Indeed, much of the debate among legal scholars can be understood as a debate about which forms/techniques of balancing are appropriate in different circumstances.

74. *Compare* Philip Morris Brand Sàrl (Switz.) v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Award, ¶ 305 (Jul. 8, 2016), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C1000/DC9012_En.pdf, *with id.* ¶ 150 (Arb. Born, dissenting).

75. *See, e.g.,* SGS Société Générale de Surveillance S.A. v. Republic of the Phil., ICSID Case No. ARB/02/6, Decision on Objections to Jurisdiction, Art. X(2) (Jan. 29, 2004), 8 ICSID Rep. 518 (2005).

76. Moreover, we show that some of most controversial and problematic cases are those in which tribunals have been engaged in balancing. *See infra* Section IV.C.2.ii.

should equal the fair market value of the expropriated investment. The fair market value of an investment is the amount that a willing buyer would pay a willing seller for the investment in an arm's length transaction immediately before the expropriation took place.[77] Conceptually, the fair market value of an investment, as a revenue-generating asset, reflects the risk-adjusted present value of the future net revenue stream of that investment.[78] Fair market value differs conceptually from other measures of compensation, such as the costs the investor has incurred in making or acquiring the investment, although tribunals have occasionally calculated compensation on this basis when there is insufficient evidence to estimate its future revenue.[79]

Investment treaties do not clarify the amount of compensation due for breaches of the treaties' other substantive provisions. (And, technically, the fair market-value standard only applies insofar as compensation is paid promptly at the time of expropriation, which is invariably not the case in claims that are litigated in investment treaty arbitration.)[80] In the absence of textual guidance, tribunals have looked to the wider principles of customary international law.[81] On this basis, tribunals have consistently applied the principle that compensation should provide "full reparation" by restoring the investor to the position it would have been in "but for" the breach of the treaty.[82] There are differences between the "full reparation" and "fair market value" principles that, in certain fact scenarios, could be significant.[83] However, in most fact scenarios, the application of the two sets of principles leads to similar, or even identical, results.[84] For present purpose, the basic

77. *See, e.g.,* Off. of the U.S. Trade Representative [USTR], U.S. Model Bilateral Investment Treaty, art. 6(2), (2012); CMS Gas Transmission Co. v. Argentine Republic, ICSID Case No. ARB/01/8, Final Award, ¶ 402 (May 12, 2005), 44 I.L.M. 1205 (2005).

78. DOLZER & SCHREUER, *supra* note 1, at 297.

79. *See, e.g.,* Wena Hotels Ltd. v. Egypt, ICSID Case No. ARB/98/4, Award, ¶¶ 123–125 (Dec. 8, 2000), 41 I.L.M. 933 (2002).

80. Expropriations that are not carried out consistently with investment treaties' requirements, including the requirement of prompt payment of compensation, are sometimes termed "unlawful" expropriations. *See, e.g.,* ADC Affiliate Ltd. v. Republic of Hung., ICSID Case No ARB/03/16, Award (Oct. 2, 2006), 18 World Trade & Arb. Materials 285 (Dec. 2006). For discussion and criticism of the lawful/unlawful expropriation distinction, see Ratner, *supra* note 11.

81. In the legal literature, the term "damages" is often used to distinguish the principles governing compensation owed for breach of an investment treaty from those governing compensation for an expropriation carried out in accordance with the treaty's provisions.

82. IRMGARD MARBOE, CALCULATION OF COMPENSATION AND DAMAGES IN INTERNATIONAL INVESTMENT LAW 72–85 (2d ed. 2017).

83. The main differences between the two principles concern the date of valuation and the range of consequential losses that the investor is entitled to recover. For detailed discussion of the application of these principles in the context of expropriation disputes, see Ratner, *supra* note 11. For a more comprehensive examination of the application of these principles in relation to expropriation disputes and other treaty breaches, see MARBOE, *supra* note 82.

84. *See, e.g.*, Crystallex Int'l Corp. v. Bolivarian Republic of Venez., ICSID Case No. ARB(AF)/11/2, Award, ¶ 843 (Apr. 4, 2017), https://www.italaw.com/sites/default/files/case-

equivalence of the two sets of principles is more important than the nuances. Regardless of which set of principles is applied, compensation for breach of an investment treaty is effectively equivalent to the investor's *loss* relative to a counter-factual future scenario in which the host state does not breach the treaty. This standard is analogous to "expectation damages" in contract law.[85]

### B. *How Our Proposal Differs from the Status Quo*

#### 1. Our Proposal

Our proposal calls for a conceptual reorientation of the principles governing liability and compensation under investment treaties. In contrast to the set of absolute protections commonly found in investment treaties, our approach is deliberately parsimonious. We propose and justify the simplest possible combination of liability rules and compensation standards that can achieve what we take to be the treaties' objective: ensuring both state parties are better off from becoming and remaining party to an investment treaty. Our proposal is that:

> i. A state should only face the possibility of having to compensate a foreign investor if the host state breaches or modifies the domestic legal regime governing the investment, and
>
> ii. Compensation should be the lesser of the investor's loss and the host state's gain from the host state not having had the new domestic legal regime in place when the investment was made. (If one of these values is zero, no compensation is required.)

As such, our proposal requires a tribunal to answer three successive questions. This section explores each of these questions in more detail. In doing so, we clarify how our proposal differs from the status quo. We also show that our proposal is practically feasible, in that it relies on sources of evidence and types of expertise that tribunals either possess themselves or are likely to have access to.

The first question is whether the host state has breached or modified the domestic legal regime that governed the investment at the time the investment was made. Such a breach or modification is a necessary, but not suffi-

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documents/italaw7194.pdf ("the Tribunal considers that in this particular case this discussion is rather theoretical and devoid of significant practical effects"); Siag v. Arab Republic of Egypt, ICSID Case No. ARB/05/15, Award, ¶ 542 (June 1, 2009), 21 World Trade & Arb. Materials 1171 (2009).

85. *See* Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980).

cient, condition for the state's liability. The focus on the domestic legal regime reflects the fact that our proposal is designed to provide states with a way to make domestic legal commitments credible, thereby solving the problem of time inconsistency of state conduct.[86] Although existing jurisprudence is not entirely consistent, this focus on stabilizing the domestic legal regime is consistent with well-established threads of jurisprudence. For example, the tribunal in *GAMI v. Mexico* explained that:

> International law does not appraise the content of a regulatory programme extant before an investor decides to commit. The inquiry is whether the state abided by or implemented that programme. It is in this sense that a government's failure to implement or abide by its own law in a manner adversely affecting a foreign investor may but will not necessarily lead to a violation of [the investment treaty].[87]

Our conception of the "*domestic legal regime*" includes the combination of rights and obligations created by any contract negotiated between the investor and the host state, as well as the powers of the host state to regulate the investment under laws in force at the time the investment is made. The domestic legal regime governing the investment defines questions such as permissible uses of land and other assets, mandatory regulatory requirements, and tax, royalty, and pricing arrangements. The domestic legal regime also defines the state's power to take action related to the investment in specified circumstances—for example, environmental laws in force when the investment is made might give the state's environmental agency the power to shut the investment down for serious and persistent noncompliance with limits on pollution. This understanding of the domestic legal regime is consistent with the position of the U.S. government, which, in submissions to investor-state arbitral tribunals, has consistently argued that "in an instance where property rights are subject to legal limitations existing at the time the property rights are acquired, any subsequent burdening of property rights by such limitations does not constitute an impairment of the original property interest."[88]

Our conception of the domestic legal regime does not, however, include expectations that foreign investors have, or may claim to have, that are not grounded in law. In this respect our proposal is narrower than existing juris-

86. *See, e.g.*, Markusen, *supra* note 20; Andrew Guzman, *Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639, 659 (1998).

87. Gami Invs. Inc. v. United Mexican States, Award, 44 I.L.M. 545, ¶ 91 (UNCITRAL, 2005).

88. Lone Pine Res. Inc. v. Gov't of Can., ICSID Case No. UNCT/15/2, Submission of the United States of America, 5 n.15 (Aug. 16, 2017), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C4406/DC10978_En.pdf.

prudence as it relates to the protection of investors' "legitimate expectations."[89]

The question of whether a state has changed or breached the domestic legal regime is a question of law, and therefore the type of question that arbitrators should be capable of answering.[90] Under existing jurisprudence, tribunals routinely decide whether a host state has changed or breached its domestic legal regime as one step in the more complex application of existing investment treaty provisions. For example, in the Argentinian gas cases, several tribunals observed that Argentina's unilateral modification of tariff rates changed the legal regime governing those investments;[91] in *Bilcon v. Canada*, the tribunal determined that the way the environmental assessment of the investor's proposal was conducted breached Canadian law.[92] Tribunals also apply domestic law in a range of other contexts under existing investment treaty jurisprudence.[93] Under our proposal, if the answer to this question is "yes," then the host state may be liable for a breach of the investment treaty, subject to the answers to the second and third question. If the answer to this question is "no," no further questions arise.

If the first question is answered affirmatively, the inquiry then moves to the second—and, potentially, the third—question. Both the second and third questions relate to the *quantum* of relevant loses and gains incurred by the disputing parties. This reveals a significant difference between the structure of our proposal and existing jurisprudence. Under existing jurisprudence,

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89. In the past, tribunals have found that investors had legitimate expectations that were derived from the generally supportive attitude of the authorities of the host state toward the investment, or from the investor's own business plans. *See, e.g.*, MTD Equity Sdn. Bhd. v. Chile, ICSID Case No. ARB/01/7, Award, ¶ 163 (May 25, 2004), 44 I.L.M 91 (2005); Walter Bau Ag. v. Thailand, Award, 22 World Trade & Arb. Materials 681, ¶¶ 12.2–12.3 (UNCITRAL, 2010). Under our proposal, such claims would inevitably fail.

90. Under normal principles of private international law, courts and tribunals are often called on to apply the law of a jurisdiction with which they may not be familiar. This is a normal and entirely unremarkable aspect of adjudication of disputes with international dimensions. Nevertheless, some commentators have argued that the quality of investment tribunals' engagement with domestic law under existing jurisprudence is patchy. *See, e.g.*, JARROD HEPBURN, DOMESTIC LAW IN INTERNATIONAL INVESTMENT ARBITRATION 192 (2017). That said, there are also many examples of good practice, and commentators have also provided constructive advice on how questions of domestic law might be resolved as a practical matter—for example, through reliance on appropriate domestic materials and expert witnesses. *Id.* at 182–92.

91. *See, e.g.,* LG&E Energy Corp. v. Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability, ¶¶ 130–134 (Oct. 3, 2006), 46 I.L.M 36 (2006).

92. Bilcon of Del., Inc. v. Gov't of Can., Permanent Ct. of Arb. [PCA] Case No. 2009-04, Award on Jurisdiction and Liability, ¶¶ 600–602 (2015), https://www.italaw.com/sites/default/files/case-documents/italaw4212.pdf.

93. For example, tribunals inevitably apply domestic law in determining the existence and extent of the investor's property rights that constitute the investment, as international law contains no rules on property rights. *See* HEPBURN, *supra* note 90, at 106; Zachary Douglas, *The Hybrid Foundations of Investment Treaty Arbitration*, 74 BRIT. Y.B. INT'L L. 151, 204 (2003).

the practical outcome of a dispute normally turns on whether the substantive protections of the investment treaty have been breached. In contrast, most of the analytical work in our proposal is done by the principles governing the quantum. The possibility of an investor obtaining compensation for minor breaches or changes to the domestic legal regime will ordinarily be excluded at this stage.

The second question is the extent of loss suffered by the foreign investor as a result of the state not having had the new domestic legal regime in place at the time that the investment was made.[94] This question involves valuation on a counter-factual basis, but the counter-factual is different from that currently used to calculate compensation for breach of investment treaties. For example, if a state imposes new restrictions on a coal-fired power station's water usage, our proposal requires the tribunal to determine what would have occurred if the restrictions were already in place prior to the investment being made. The evidence required to construct this *past* counter-factual can be found in the historical record, particularly as it relates to the investor's investment decision and actually incurred expenses. In contrast, the principles that currently govern compensation under investment treaties require a tribunal to determine the future scenario that would have existed if the restrictions had not been introduced.[95] Constructing a *future* counter-factual of this sort requires a complex set of interlocking forecasts about the situation the investor would have been in but for the host state's breach of the investment treaty. For this reason, answering the second question posed by our proposal will normally be simpler than the valuation exercise required to calculate compensation under existing jurisprudence.

In many situations that are controversial under existing jurisprudence, the outcome under our proposal is straightforward. Consider, for example, situations in which an investor would have proceeded with the investment even if the new domestic legal regime had been in place when the investment was made. Regulatory changes that reduce profitability of an investment without undermining its financial viability fall into this category.[96] In these cases, there is no relevant loss to the investor, as the investor is not left worse off than if it had decided not to invest in the first place. No compensation is due under our proposal.

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94. In situations where the state has *breached* the pre-existing domestic legal regime, the "new" domestic legal regime refers to a domestic legal regime that authorizes the conduct in question. In situations where the state has *changed* the pre-existing domestic legal regime, the "new" domestic legal regime refers, obviously, to the domestic legal regime after the change.

95. These precise circumstances were at issue in *Vattenfall v. Germany I*, but it is important to note that the *Vattenfall I* arbitration settled prior to any determination of the merits of the investor's claim. As such, it is unclear whether the tribunal would have found a breach of the Energy Charter Treaty, requiring compensation. Vattenfall AB, v. Republic of Ger. (I), ICSID Case No. ARB/09/6, Award Embodying the Parties' Settlement Agreement (Mar. 11, 2011), https://www.italaw.com/sites/default/files/case-documents/ita0890.pdf.

96. *See* discussion *infra* Section IV.C.2.ii.

In other circumstances, the foreign investor would not have proceeded with the investment if the new domestic legal regime had been in place from the outset. This will normally be the case where a host state's breach or change to its domestic legal regime leads to the termination of an investment. It will also be the case in some situations in which the investment continues to operate, insofar as breach or change to the domestic legal regime makes it impossible for the investor to recover the capital it initially invested. In both situations, our second question is equivalent to the standard of "reliance damages" in contract law[97]—i.e. compensation is the amount the investor has lost by investing in reliance on the domestic legal regime in place at the time that the investment was made. This loss is equal to the amount originally invested by the investor adjusted to include the cost of capital, minus revenue income earned from the operation of the investment. Interest would be calculated on the basis of the investor's cost of capital. This standard for calculating compensation is within arbitrators' experience. Several investment treaty tribunals have calculated compensation on the basis of an investor's sunk costs,[98] in circumstances where there was insufficient evidence to support the complex set of interlocking forecasts necessary to award compensation on a "but for" basis.[99]

The third question concerns the amount that the host state has gained from not having had the new domestic legal regime in place at the time that the investment was made. This is equivalent to one the methods for determining the "restitution interest" in contract law.[100] Under this conception of

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97. *See* Shavell*, supra* note 85, at 471.

98. *See* Compañia de Aguas del Aconquija S.A. v. Argentine Republic, ICSID Case No. ARB/97/3, Award, ¶¶ 8.3.3–8.3.13 (Aug. 20, 2007), https://www.italaw.com/sites/default/files/case-documents/ita0215.pdf;); Bear Creek Mining Corp. v. Republic of Peru, ICSID Case No. ARB/14/21, Award, ¶¶ 590, 633 (Nov. 30, 2017), 30 World Trade & Arb. Materials 5 (2018).

99. *See* SERGEY RIPINSKY & KEVIN WILLIAMS, DAMAGES IN INTERNATIONAL INVESTMENT LAW 206–07 (2008) (citing Metalclad Corp. v. United Mexican States, ICSID Case No. ARB(AF)/97/1, Award (Aug. 30, 2000), 40 I.L.M. 36 (2001); Wena Hotels Ltd. v. Arab Republic of Egypt, ICSID Case No. ARB/98/4, Award, ¶¶ 124–125 (Dec. 8, 2000), 41 I.L.M. 933 (2002); Técnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award (May 29, 2003), 43 I.L.M. 133 (2004); S. Pac. Props. Ltd. v. Arab Republic of Egypt, ICSID Case No. ARB/84/3, Award (May 20, 1992), 32 I.L.M. 1470 (1993)); *see also* Louis Wells, *Double Dipping in Arbitration Awards? An Economist Questions Damages Awarded to Khara Bodas Company in Indonesia* 19 ARB. INT'L 471, 475 (2003).

100. According to the restatements, one measure "of money . . . awarded to protect a party's restitution interest," is "the extent to which the other party's property has been increased in value or his other interests advanced." RESTATEMENT (SECOND) OF CONTS. § 371(b) (Am. Law Inst. 1981). For an example, see Bush v. Canfield 2 Conn. 485 (Conn. 1818). In contract law, calculation of compensation on a restitutionary basis is normally used when expectation damages are judged to be insufficient. This differs from our proposal, which will almost inevitably lead to lower awards of compensation than would be the case under the principle of full reparation.

restitution "the defaulting party returns only the payments made to him."[101] This is the most innovative aspect of our proposal, as compensation is rarely awarded on a restitution basis in international law.[102]

The third question only arises if the first two questions have been answered affirmatively—i.e. if the host state has breached or changed the domestic legal regime, and the investor has suffered a loss due to the state not having had the new domestic legal regime in place when the investment was made. The answer to this third question is based on comparison to the same counter-factual used to answer the second question, which considerably simplifies the inquiry. The difference is that the third question concerns the host state's gain, rather than the investor's loss, relative to this counter-factual. As with the second question, the evidence required to answer the third question can be found in the historical record. Relevant evidence will include documentation of amounts actually paid to the state in order to obtain permits and concessions, as well as valuation of any assets or resources transferred into state ownership during the lifespan of the investment.[103] Once the value of the relevant gain to the host state is determined, interest would be calculated on the basis of the host's cost of capital and applied from the date at which the gain was obtained until the date the award is paid, to reflect the time value of money.

The inquiry necessary to answer the third question illustrates the underlying logic of our rule—namely, protecting investors from legal change only insofar as is necessary to solve problems of time inconsistency for the host state. Consider, for example, the case of *Bilcon v. Canada*. The case concerned an investor's proposal to build and operate a gravel quarry in the province of Nova Scotia. The investor claimed that it was originally encouraged to proceed with project by the provincial authorities and spent several million dollars developing its proposal.[104] However, many members of the

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101. Shavell, *supra* note 85, at 471.

102. Confusingly, the term "restitution" is also used in international law as shorthand for an order of restitution *of property—e.g.*, transfer of property back to a claimant following an illegal expropriation. Int'l Law Comm'n, Draft Articles on Responsibility of States for Internationally Wrongful Acts, U.N. Doc. A/56/10, art. 34 (Oct. 24, 2001); *see, e.g.*, Factory at Chorzów (Ger. V. Pol.), 1928 P.C.I.J (ser. A) No. 17, at 43 (Sept. 13). An order for restitution of property should be clearly distinguished from calculation of compensation on the basis of restitution, as the term is used in contract law. The latter is focused on determining the amount that the defaulting party has gained, independently of the question of how much the innocent party has lost.

103. In our companion paper, the superior efficiency and equity properties of our rule were proven, assuming that gain was net of losses and that both losses and gains were broadly defined to include everything from tax revenue to social and environmental costs and benefits. *See, e.g.*, Aisbett & Bonnitcha, *supra* note 12, at 22 (analyzing Case 3c). Later in this paper, we provide examples of how these principles could be operationalized in investment disputes as a practical matter. *See infra* Section IV.C.2.ii.

104. Bilcon of Del., Inc. v. Gov't of Can., Permanent Ct. of Arb. [PCA] Case No. 2009-04, Award on Jurisdiction and Liability, ¶¶ 455–471 (2015), https://www.italaw.com/sites/default/files/case-documents/italaw4212.pdf.

local community opposed the project and, partly for this reason, the Canadian environmental review process refused to grant the permission necessary for the project to go ahead.[105]

The tribunal held that this decision was made in breach of Canadian environmental law, meaning that Canada's action is potentially compensable under our proposal. As to the second question, if Canadian environmental law had clearly precluded the project from going ahead *prior* to the time at which Bilcon began its development activities, it seems clear that the investor would not have spent its money pursuing the project. As such, the investor suffered a potentially compensable loss under our proposal. However, turning to the third question, there is no evidence that Canada gained anything from Bilcon's pre-development activities, so no compensation is due. This is a situation where the investor has suffered a loss due to the changing political priorities of the host state, not a case of opportunistic action where a state has encouraged an investment and then "changed the rules" so as to acquire the value of the investment. (The outcome under our proposal would be different if Canada had *sold* Bilcon the right to build a quarry on a particular location, and subsequently refused to grant permission for the development to proceed.)

### 2. Some Further Case Examples

In this section we explore the practical implications of our proposal, using a series of well-known investment treaty disputes as examples. Following our companion paper, we divide our discussion between cases in which state conduct completely destroys an investment, and cases in which state conduct leads to a partial reduction in the value of an investment that continues to operate.

#### i. Cases Involving Expropriation and/or Permanent Shut-Down of an Investment

Under our proposal, compensation will not necessarily be required for state conduct that shuts-down or entirely eviscerates an investment. This is one important difference between our proposal and existing investment treaties. Consider the case of *Metalclad v. Mexico*. 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 authorizations. When construction was well underway, the municipality issued a stop work order, claiming that 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. The

105. *Id.* ¶¶ 502–506.

municipality's action appears to have been in breach of Mexican law.[106] But, for the tribunal, the two decisive factors were that Metalclad had been led to believe that it was not required to obtain a construction permit, and that municipality's stop work order had then completely destroyed the value of its investment.[107]

Under our proposal the threshold question is whether the municipality's conduct was consistent with Mexican law. It appears that it was not. The second question is whether Metalclad suffered any loss compared to the situation that would have existed if the Mexican legal system had prohibited the investment from the outset. Clearly, Metalclad did suffer such a loss—specifically, the expense of constructing the facility that it unable to recover. This was the basis on which compensation was actually awarded in that case.[108] Nevertheless, Metalclad's claim fails to satisfy the third test imposed by our proposal, as Mexico did not obtain any benefit from not having prohibited the investment from the outset. In proceeding with the investment, Metalclad did not make any payment to Mexican government entities or contribute to the provision of any public infrastructure subsequently repurposed by Mexico. Mexico did not acquire ownership of any of Metalclad's assets, such as the landfill site, the ownership of which was retained by Metalclad.[109] As such, no compensation would be due under our proposal.[110]

Lawyers for investor-claimants might be tempted to argue that an investor's expenditure within the territory of a host state constitutes a "gain" to that state by virtue of its effect in stimulating the local economy. The argument, in this case, would be that Mexican economy benefited from the money Metalclad spent constructing the facility. However, such expenditure diverts productive resources, including labor, from other economic activities. In order to make a case, on the facts, that Metalclad's expenditure *in itself* constituted a gain for the host state, the investor would need to show that the employment generated was additive, for example by showing that the employees were paid more than their alternative wage or income, or that the

106. *See* Metalclad Corp. v. United Mexican States, ICSID Case No. ARB(AF)/97/1, Award, ¶ 86 (Aug. 30, 2000), 40 I.L.M. 36 (2001).

107. *Id.* ¶¶ 81–86, 103.

108. *Id.* ¶ 122.

109. *Id.* ¶ 127

110. This example illustrates one important difference between our proposal and an earlier proposal made by Newcombe, *supra* note 46. Newcombe has argued that regulatory expropriation jurisprudence under investment treaties should be organized around the concept of appropriation. Although his terminology appears similar to ours, he would treat the cancellation of a license or permit as a "quasi-appropriation" requiring compensation because "the state is essentially reacquiring rights that it can use or grant to another party in the future." Newcombe, *supra* note 46, at 19, 22. Unlike our proposal, his analysis does not depend on whether the investor had to pay the state to acquire the license or permit in question. The difference between our approaches stems from the fact that our argument is grounded in an economic analysis of the problem of time inconsistency, whereas his argument is animated by concerns of fairness to the investor. Newcombe, *supra* note 46, at 55.

income tax collected was higher than if the project not taken place. The compensation due would then be the difference between the actual wages and taxes paid and the economic situation that would have existed in the absence of the investor's expenditure. As a conceptual point, any such "gain" to the host state will necessarily be less than the amount actually expended by the investor. As a practical point, investors bear the evidentiary burden of substantiating their claims in investment treaty arbitration,[111] so such arguments would only be likely to succeed in situations where an investor can adduce specific and concrete evidence its wasted expenditure in pursuing an investment created benefits for the host state's economy.

Insofar as compensation is required for the shut-down of an investment under our proposal, the amount of compensation required will invariably be lower than is the case under currently existing investment treaties. *Al Kharifi v. Libya* provides a simple illustration. The dispute in this case concerned a 2006 agreement between a foreign investor and Libya for the investor to build and operate a new hotel. From the description of the facts in the award, it seems that the investor had spent $5 million U.S. dollars ("USD") over four years pursuing the project before it was cancelled by Libya in 2010.[112] This included an initial payment of $130,000 U.S. dollars ("USD") to the Libyan Treasury.[113] Even though construction of the project never commenced, the arbitral tribunal awarded $900 million USD to the investor on the basis that, if Libya had not cancelled the project, the investment would have been highly profitable for the investor for the eighty-two year period of the investment's proposed duration.[114] (In June 2020, the award was annulled by Egyptian courts, due to the disproportionate amount of compensation awarded.)[115] Under our proposal, compensation would also be due as a result of Libya's breach of the underlying project agreement. But the amount of compensation would be the lesser of the investor's pre-development expenditures and the investor's payment to Libya—i.e. $130,000 USD. Interest and would run from the date the investor made the payment to the Libyan Treasury until the award was paid, with the interest rate set at Libya's cost of capital.

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111. For discussion of a party's evidentiary burden to prove the facts on which its claim rests, see FRÉDÉRIC GILLES SOURGENS, KABIR DUGGAL & IAN A. LAIRD, EVIDENCE IN INTERNATIONAL INVESTMENT ARBITRATION 26–28 (2018).

112. *See* Al-Kharafi & Sons Co. v. Libya, Award, 367–68 (Cairo Reg'l Ctr. For Int'l Com. Arb, 2013), https://www.italaw.com/sites/default/files/case-documents/italaw1554.pdf.

113. *Id.* at 18.

114. *Id.* at 382. An additional complication in this case is that it was argued on the basis that the Libya had breached both the relevant investment treaty (the Unified Agreement for the Investment of Arab Capital) and the underlying investment contract with the investor. For this reason, the tribunal argued that it had "discretion" in determining the amount of compensation, and then relied on principles of Libyan law to justify its approach. *See id*. at 364–65.

115. Mah. Kamat al-Isti'n f [Court of Appeal], Cairo, Judgment No. 39, session of 3 June 2020, year 130 (Egypt).

One important feature of our rule is that it does not require tribunals to assess the strength or validity of public policy justifications for the host state's conduct. Consider the case of *Crystallex v. Venezuela*. In that case, the foreign investor had made a series of payments to the Venezuelan government and to a Venezuelan state-owned enterprise to acquire mining rights for the *Las Christinas* site. Venezuelan authorities subsequently rejected the investor's application to develop the site citing "concerns for the environment and the indigenous people of the Imataca Forest Reserve."[116] The arbitral tribunal found that Venezuela's action breached the investment treaty. Even though the mine was never built, the tribunal awarded the investor $1.2 billion USD in compensation, reflecting the tribunal's estimate of the likely value of the mine if it had been allowed to go ahead.

Our proposal would also require compensation in this situation due to Venezuela's apparent breach of its own legal regime,[117] regardless of the validity of the environmental and indigenous concerns that Venezuela cited to justify the measure. However, the amount of compensation due would be the lesser of Crystallex's loss from having made the investment and Venezuela's gains arising from Crystallex's investment (including gains to Venezuelan state-owned entities). The tribunal did not quantify either amount, as neither is decisive under existing jurisprudence.

The tribunal did, however, indicate that Crystallex's investment related-expenses fell in the range between $200 million USD (Venezuela's estimate) and $645 million USD (Crystallex's estimate).[118] The tribunal also identified all the elements necessary to value the benefit of Crystallex's investment activity to Venezuela. These were the $15 million USD that Crystallex paid to the Venezuela state-owned enterprise to acquire the *Las Christinas* mining rights,[119] the unspecified amounts Crystallex paid to Venezuela as a bond and in environmental taxes,[120] and the value to Venezuela of public infrastructure, including a medical center that Crystallex constructed under the project agreement.[121] From this description of the facts, the benefit of Crystallex's investment activity to Venezuela was almost certainly less than Crystallex's losses arising from its investment related-

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116. Crystallex Int'l Corp. v. Bolivarian Republic of Venez., ICSID Case No. ARB(AF)/11/2, Award, ¶ 44 (Apr. 4, 2017), https://www.italaw.com/sites/default/files/case-documents/italaw7194.pdf.

117. In order to decide whether Venezuela had breached the investment treaty, the *Crystallex* tribunal engaged in an elaborate analysis of the investor's expectations. It did not directly answer the simpler question of whether Venezuela's rejection of the investor's application breached its own legal regime. But, insofar as the tribunal touched on the question, it appears that there Venezuela did breach its own legal regime governing the evaluation and approval of mining permit applications. *See, e.g.*, *id*. ¶ 614.

118. *Id*. ¶¶ 912–913.

119. *Id*. ¶ 18.

120. *Id*. ¶ 245.

121. *Id*. ¶ 194.

expenses, meaning that compensation under our proposal would be the former. Either way, on these facts, our proposal leads to compensation vastly lower than that currently required under investment treaties.

### ii. Cases Involving Interference with Investments that Continue to Operate

One attractive feature of our proposal is that it provides a simple way to resolve complex—and often highly controversial—*regulatory* disputes relating to foreign investment. Consider the example of *Philip Morris v. Australia*. As is well known, the dispute concerned a change to Australia's domestic legal regime: the introduction of a law mandating plain packaging for tobacco products. Philip Morris's central argument was that this regulatory change was arbitrary and unjustified, in the sense that it was unlikely to reduce tobacco consumption.[122] The case was dismissed on jurisdictional grounds, so the tribunal never decided whether Australia's conduct would have breached the investment treaty.[123]

Under our proposal, the threshold question is whether there was a change in Australia's legal regime after Philip Morris invested in Australia. The answer is clearly yes (leaving aside complications arising from the restructuring of Philip Morris business that ultimately led to the claim being dismissed).[124] The second question is whether Philip Morris suffered a loss compared to the situation that would have existed if Australia had had tobacco plain packaging rules in force prior to the time at which Philip Morris first established its Australian operations. The answer to this question is clearly "no." The sale of tobacco products in Australia remained a highly profitable business, even after the introduction of the new law mandating plain packaging.[125] This demonstrates that Philip Morris would have invested anyway, even if the new laws had been in place from the outset and, therefore, that there was no relevant loss to the investor. Under our proposal, no compensation is due, independently of an inquiry into the strength of the public health justification offered by Australia for its legal change.

Nevertheless, there will be circumstances where our proposal requires compensation for interferences with investments that continue to operate. The series of disputes arising from changes to the regulatory regime govern-

122. *See, e.g.,* Philip Morris Asia Ltd. v. The Commonwealth of Austl., PCA Case No. 2012-12, Notice of Arbitration, ¶ 7.7 (2011), https://www.italaw.com/sites/default/files/case-documents/ita0665.pdf.

123. Philip Morris Asia Ltd. v. The Commonwealth of Austl., PCA Case No. 2012-12, Award on Jurisdiction and Admissibility, ¶ 588 (2015), https://www.italaw.com/sites/default/files/case-documents/italaw7303_0.pdf.

124. For a summary, see *id.* ¶¶ 141–164.

125. *See* Michelle Scollo & Megan Bayly, *The Manufacturing And Wholesaling Industry In Australia—Major International Companies*, *in* TOBACCO IN AUSTRALIA: FACTS AND ISSUES (M.M. Scollo & M.H. Winstanley eds., 2019), https://www.tobaccoinaustralia.org.au/chapter-10-tobacco-industry/10-3-the-manufacturing-and-wholesaling-industry-in-australia.

ing investments in solar power generation in Spain provide one example of a situation where compensation might be required under our rule. In the 2000s, Spain established a regulatory regime with the aim of encouraging investment in renewable energy. Generators of renewable energy were given the choice between a fixed tariff or a premium over and above market tariff paid to other electricity providers.[126] These tariffs were to be reviewed every four years, subject to the proviso that "a reasonable rate of profitability shall always be guaranteed with reference to the cost of money in the capital markets."[127] The regime was more successful than anticipated in attracting new investment in renewable energy. However, following the 2008 financial crisis, demand for electricity in Spain fell sharply. As a result of these two factors, the "tariff deficit"—the gap between the amount the Spanish state was paying to purchase renewable electricity and the revenue that it could cover from the on-sale of that electricity for consumption—increased to over €20 billion Euros.[128] In response to domestic political pressure for reform, as well as pressure from the International Monetary Fund and the European Commission,[129] Spain dismantled the existing regulatory regime in a series of steps. In the final step, from 2013, existing renewable energy generators were paid only the market price for electricity, plus an additional Special Payment (subsidy) benchmarked according to the costs of building and operating an efficient renewable energy plant and intended to ensure that such a plant would still be able to achieve a return of 7.398 percent per annum over its life cycle.[130]

These regulatory changes have led to over forty ISDS claims against Spain.[131] Many of these cases remain pending. Of those that have been resolved, investors have won eleven, while Spain has successfully defended three.[132] Some of these differences in outcome can, arguably, be justified by differences in the factual specifics in the underlying cases.[133] Others are ex-

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126. RREEF Infrastructure (G.P.) Ltd. v. Kingdom of Spain, ICSID Case No. ARB/13 /30, Decision on Responsibility and on the Principles of Quantum, ¶ 109 (Nov. 30, 2018), https://www.italaw.com/sites/default/files/case-documents/italaw10455_0.pdf.

127. *Id.* ¶ 114.

128. *Id.* ¶ 116.

129. Tobias Buck, *Spanish Energy Reforms Slash Subsidies to Suppliers,* FIN. TIMES (July 13, 2013), https://www.ft.com/content/a7e539a8-eb0c-11e2-bfdb-00144feabdc0.

130. RREEF Infrastructure (G.P.) Ltd v. Kingdom of Spain., ICSID Case No. ARB/13 /30, Decision on Responsibility and on the Principles of Quantum, ¶¶ 132–141.

131. *See Investment Dispute Settlement Navigator*: *Spain Cases as Respondent State*, U.N. CONF. ON TRADE & DEV., https://investmentpolicy.unctad.org/investment-dispute-settlement/country/197/spain/investor (last visited Nov. 8, 2020).

132. *Id.*

133. Yulia S Selivanova, *Changes in Renewables Support Policy and Investment Protection Under the Energy Charter Treaty: Analysis of Jurisprudence and Outlook for the Current Arbitration Cases*, 33 ICSID REV. 433, 451 (2018) (comparing Isolux Neth. BV v. Kingdom of Spain, SCC Case V2013/153, Final Award (2016), https://www.italaw.com/sites/default /files/case-documents/italaw9219.pdf, with Eiser Infrastructure Ltd. v. Kingdom of Spain,

amples of divergent outcomes on substantially identical facts.[134] The differences between the outcomes in the cases that have been decided to date turn largely on tribunals' assessment of the "legitimate expectations" of the investor in question and on the tribunals' views about whether the regulatory changes were "reasonable."[135] In those cases where investors have succeeded, tribunals have had to evaluate complex financial evidence to determine the amount of compensation due under existing jurisprudence.

Our proposal provides a better way to resolve such cases. The first question is whether Spain changed the domestic legal regime governing existing solar investments. The answer is clearly "yes." The second question concerns the loss that the investor in question suffered compared to the situation that would have existed if the new subsidy regime had been in place from the time at which it made its investment. This loss is equal to the amount originally invested by the investor adjusted to include the cost of capital over the operating life cycle of the project, minus the operating income that the investment generated both before and after the new regime was introduced.

Although most of the Spanish solar tribunals to date have—consistently with existing jurisprudence—calculated compensation according to the principle of "full reparation,"[136] the tribunal in *RREEF v. Spain* held that compensation should be calculated in order to ensure that the investor ob-

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ICSID Case No. ARB/13/36, Final Award (May 4, 2017), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C3286/DS14433_En.pdf).

134. Lisa Bohmer, *Analysis: Majority in Stadtwerke Munchen v. Spain Considers That Investors in Spanish CSP Plants Could Not Legitimately Expect Legislative Stability; Kaj Hober Disagrees*, INV. ARB. REP. (Dec. 5, 2019), https://www.iareporter.com/articles/analysis-majority-in-stadtwerke-munchen-v-spain-considers-that-investors-in-spanish-csp-plants-could-not-legitimately-expect-legislative-stability-kaj-hober-disagrees/ (comparing Stadtwerke München GmbH v. Spain, ICSID Case No. ARB/15/1, Award (Dec. 2, 2019), https://www.italaw.com/sites/default/files/case-documents/italaw11056.pdf, with OperaFund Eco-Invest SICAV PLC v. Spain, ICSID Case No. ARB/15/36, Award (Sept. 6, 2019), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C4806/DS12832_En.pdf, NextEra Energy Global Holdings B.V. v. Spain, ICSID Case No. ARB/14/11, Final Award (May 31, 2019), 31 World Trade & Arb. Materials 987 (2019), and Foresight Lux. Solar 1 S.à.r.l. v. Spain, SCC Case No. 2015/150, Final Award (2018), https://www.italaw.com/sites/default/files/case-documents/italaw10142.pdf).

135. *See, e.g.,* 9REN Holding S.à.r.l. v. Spain, ICSID Case No. ARB/15/15, Award, ¶¶ 212–216 (May 31, 2019), https://www.italaw.com/sites/default/files/case-documents/italaw10565.pdf; Isabella Reynoso, *Spain's Renewable Energy Saga: Lessons for International Law and Sustainable Development*, INST. FOR SUSTAINABLE DEV. (June 27, 2019), https://www.iisd.org/itn/en/2019/06/27/spains-renewable-energy-saga-lessons-for-international-investment-law-and-sustainable-development-isabella-reynoso/.

136. Novenergia II—Energy and Env't (SCA) (Grand Duchy of Lux.), SICAR v. Kingdom of Spain, SCC Case No. 2015/063, Final Arbitral Award, 30 World Trade & Arb. Materials 947, ¶¶ 803–847 (2018).

tained a reasonable rate of return.[137] To perform these calculations, the *RREEF* tribunal assessed the investor's initial expenditure, determined the cost of capital, added an additional increment to allow the investor some excess profit to arrive at a reasonable rate of return, and then determined the extent to which the new regulatory regime failed to ensure this rate of return on an ongoing basis.[138] The *RREEF* tribunal's analysis illustrates that the inquiry required by our second question is feasible, as a practical matter. However, one difference between our approach and that adopted by the tribunal in *RREEF* is that our approach would take the very generous returns that investors earned prior to the change in the regulatory regime into account.[139] Another is that our approach relies on the cost of capital only; compensation should not include any allowance for excess profitability over and above the cost of capital.

The third question under our approach concerns Spain's gain from not having had the new regime in place. This question draws attention to an important conceptual challenge facing existing jurisprudence. In the case of *RREEF v. Spain*, for example, the investor-claimant was not the company that had originally constructed the solar plants. Rather, the claimant in the case was an asset-manager that had purchased a stake in solar plants several years after construction, having been attracted by the above-market returns available in that sector under the original regulatory regime.[140] In *RREEF*, this factual quirk led to the bizarre outcome that the claimant (the asset-manager) likely obtained *more* in compensation than the original investor would have obtained in the same case, on account of the fact that the asset-manager paid more to buy the investment than the investment had initially cost to build. There is no plausible policy justification for such an outcome.

The third question in our proposal deals with this problem in a straightforward way, by focusing on the gain that the host state has obtained from not having had the new regulatory regime in place when the initial investment was made.[141] Conceptually, there is a gain to the state if it induced the

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137. *See* RREEF Infrastructure (G.P.) Ltd. v. Kingdom of Spain, ICSID Case No. ARB /13/30, Decision on Responsibility and on the Principles of Quantum, ¶ 515 (Nov. 30, 2018), https://www.italaw.com/sites/default/files/case-documents/italaw10455_0.pdf.

138. *Id.* ¶¶ 567–591 (detailing this methodology). Some of the final calculations carry over to RREEF Infrastructure (G.P.) Ltd. v. Kingdom of Spain, ICSID Case No. ARB/13/30, Award, ¶ 19 (Dec. 11, 2019), https://www.italaw.com/sites/default/files/case-documents /italaw10455_0.pdf.

139. This follows from the fact that our inquiry seeks to measure the loss the investor has suffered compared to the situation that would have existed if the new, less generous, regime had been in place from the time at which the investment was made. *Cf.* RREEF Infrastructure (G.P.) Ltd. v. Kingdom of Spain, ICSID Case No. ARB/13/30, Decision on Responsibility and on the Principles of Quantum, ¶ 590 (Nov. 30, 2018), https://www.italaw.com /sites/default/files/case-documents/italaw10455_0.pdf.

140. *Id.* ¶¶ 142–177.

141. If the new regulatory regime had been in place when the asset-manager was contemplating buying the solar plants from the original, there is no doubt that the sale would not

investment by offering a generous regulatory regime before switching to a less generous regime after the initial investor had incurred the significant sunk costs involved in building the solar plants. As a practical matter, the value of that gain to the state is the value of the renewable energy obtained from the investment, less the amount actually paid for that electricity, with both figures calculated over the operating life cycle of the investment. The value of the renewable electricity is the amount it would have cost an efficient operator to produce that electricity using the technology in question at the time the investment was made. These calculations could be performed using information that is readily available to arbitral tribunals—specifically, cost data from other operators in the solar industry. Indeed, it seems that Spain actually led evidence in several of the arbitrations relating to the cost structure of efficient solar plants, as this benchmark was one of the principles underpinning both the original and the new regulatory regimes.[142] While investor-claimants took the view that these figures underestimated the costs facing real plants,[143] this is a debate that could have been resolved through further evidence. In several of the Spanish solar cases it is likely that gain to the host state calculated in this way would be zero, meaning that no compensation would be due.

### C. *Our Proposal Resolves Practical Challenges with Existing Jurisprudence*

In Part IV.A, we showed that balancing, as a mode of reasoning, is central to existing arbitral jurisprudence. This mode of reasoning requires tribunals to evaluate the policy justifications for state conduct. While there are differences between balancing techniques, particularly as they relate to the level of deference shown to the host state's own decision-making process,[144] existing tribunals are regularly drawn into controversial inquiries about states' motives, and the purpose and effectiveness of measures that are subject to challenge.

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have gone ahead. However, Spain gained nothing from that transaction. Therefore, treating this transaction as an "investment" would mean that no compensation is due. *See id.* ¶ 163.

142. *Id.* ¶ 542; Isolux Neth., BV v. Kingdom of Spain, SCC Case V2013/153, Final Award ¶ 134 (July 17, 2016), https://www.italaw.com/sites/default/files/case-documents/italaw9219.pdf.

143. Selivanova, *supra* note 133, at 449.

144. For discussion of the appropriate level of deference in investment treaty arbitration, *see generally* William W. Burke-White & Andreas von Staden, *Private Litigation in a Public Sphere: The Standard of Review in Investor-State Arbitrations*, 35 YALE J. INT'L L. (2010); Stephan W. Schill, *Deference in Investment Treaty Arbitration: Re-conceptualizing the Standard of Review Through Comparative Public Law* (Soc'y Int'l Econ. L. 3rd Biennial Glob. Conf. Working Paper No. 2012/33, 2012); Anna T. Katselas, *Do Investment Treaties Prescribe a Deferential Standard of Review*, 34 MICH. J. INT'L L. 87 (2012); Caroline Henckels, *Balancing Investment Protection and the Public Interest: The Role of the Standard of Review and the Importance of Deference in Investor-State Arbitration* 4 J. INT'L DISP. SETTLEMENT 197 (2013).

In contrast, our proposal does not require tribunals to resolve any of the questions that ordinarily arise within a balancing mode of reasoning. Under our proposal, inquiry into that state's motive is not relevant, meaning that a tribunal is not required to unpick the decision-making process leading to the change in the domestic legal regime. This means that a tribunal is not required to determine whether the state is genuinely motivated by environmental considerations in cases like *Metalclad* and *Tecmed*, discussed previously.[145] The objective of the state's measure is not relevant, meaning that the tribunal is not required to take a view on which government purposes are legitimate.[146] This means, for example, that tribunals do not need to resolve debates within existing jurisprudence about if and, if so, when a state is entitled to change its domestic legal regime to reduce very high rates of profitability being obtained by operators in regulated industries or natural monopolies.[147]

The effectiveness of the state's measure is also not relevant under our proposal, meaning that the tribunal is not required to reassess the evidentiary basis for the state's conduct, or to come to a view about the reasonableness of the state's own assessment of the evidentiary basis. This would avoid the need for tribunals to resolve issues such as the disagreement between the majority and minority arbitrators in *Philip Morris v. Uruguay* about whether Uruguay's restrictions on marketing of brand variants of tobacco products had a sufficient evidentiary basis.[148] Finally, the balance a state has struck between competing interests is not relevant, meaning that the tribunal is not required to ascribe weights to competing policy objectives, or to review the weighting of objectives implicit in state action. This would resolve the challenges faced by the tribunals in the Spanish solar cases, discussed above, in determining how far Spain could legitimately alter

145. *See supra* Section IV.b.2.i for discussion of Técnicas Medioambientales Tecmed S.A. v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award (May 29, 2003), 43 I.L.M. 133 (2004).

146. For the argument that existing jurisprudence requires tribunals to take a view, explicitly or implicitly, on which purposes are legitimate, see Allen S. Weiner, *Indirect Expropriations: The Need for a Taxonomy of "Legitimate" Regulatory Purposes*, 5 INT'L L.F. 166 (2003).

147. For the view that host states are generally entitled to take action to reduce "excess profits," see AES Summit Generation Ltd. v. Republic of Hung., ICSID Case No. ARB/07/22, Award, ¶ 10.3.9 (Sep. 23, 2010), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C114/DC1730_En.pdf. For the view that the provision of above market rates of return are "bait" to attract foreign investment that a state cannot then renounce, see Novenergia II—Energy and Env't (SCA) (Grand Duchy of Lux.), SICAR v. Kingdom of Spain, Arb. Inst. Of the Stockholm Chamber of Com. [SCC] Case No. 2015/063, Final Arbitral Award, 30 World Trade & Arb. Materials 947, ¶ 694 (2018). For discussion of these issues in other contexts, see Rose-Ackerman & Rossi, *supra* note 29.

148. *Compare* Philip Morris Brand Sàrl (Switz.) v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Award, ¶ 305 (Jul. 8, 2016), http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C1000/DC9012_En.pdf, *with id.* ¶ 150 (Arb. Born, dissenting).

the 2007 regulatory regime governing investment in solar power generation without incurring liability under investment treaties.[149]

By removing the need for tribunals to evaluate the justifications for state conduct, our proposal resolves several challenges with existing jurisprudence. First, there is the question of institutional competence. Almost all arbitrators are lawyers, and the majority of them have a background in private, commercial practice. Many of the strongest criticisms of investment treaty arbitration in its current form focus on arbitrators' suitability to pass judgment on complex questions of public policy.[150] Our proposal does not require arbitrators to answer such questions.

Second, there is the complexity of investment treaty arbitration, with associated implications for the expense and duration of proceedings.[151] Because balancing as a mode of reasoning invites argument about the policy justifications for state conduct, it significantly increases the complexity of proceedings. For example, in the course of its successful defense of its tobacco packaging law, Australia led evidence from twelve expert witnesses on issues such as the strength of the public health evidence supporting the law.[152] It cost Australia at least 23 million Australian Dollars to defend the claim (approximately $16 million USD), only half of which was ultimately reimbursed by the claimant as a result of the tribunal's costs order.[153]

If a state is found to have breached an investment treaty, further complexity and associated cost arises in the determination of compensation. For example, in *Crystallex v. Venezuela* led evidence in relation to four different valuation methods which could be used to construct a future counter-factual against which the claimant's loss could be measured. Each of these valuation exercises was supported by underlying expert evidence and an associat-

149. For a similar argument, see Frederico Ortino, *Investment Treaties, Sustainable Development and Reasonableness Review: A Case Against Strict Proportionality Balancing*, 30 LEIDEN J. INT'L L. 71 (2017).

150. GUS VAN HARTEN, INVESTMENT TREATY ARBITRATION AND PUBLIC LAW (2007); GUS VAN HARTEN, SOVEREIGN CHOICES AND SOVEREIGN CONSTRAINTS: JUDICIAL RESTRAINT IN INVESTMENT TREATY ARBITRATION (2013); BONNITCHA ET AL., *supra* note 1, at 253–57.

151. For data on costs and duration of existing proceedings, see BONNITCHA ET AL., *supra* note 1, at 87–91; Gabriel Bottini, Julien Chaisse, Marko Jovanovic, Facundo Pérez Aznar & Catherine Titi, *Excessive Costs and Recoverability of Costs Awards in Investment Arbitration* (Academic F. ISDS Concept Paper 2019/9, 2019); Anna De Luca, Crina Baltag, Daniel Behn, Holger Hestermeyer, Gregory Shaffer, Jonathan Bonnitcha, José Manuel Alvarez-Zarate, Loukas Mistelis, Malcolm Langford, Clara López Rodríquez & Simon Weber, *Duration of ISDS Proceedings* (Academic F. ISDS Concept Paper 2020/1, 2020).

152. Philip Morris Asia Limited v. The Commonwealth of Austl., PCA Case No. 2012-12, Final Award Regarding Costs, ¶ 86 (P.C.A. July 8, 2017), https://www.italaw.com/cases/851.

153. Jarrod Hepburn, *Final Costs Details are Released in Philip Morris v. Australia Following Request by IAReporter,* INT'L ARB. REP. (Mar. 21, 2019), https://www.iareporter.com/articles/final-costs-details-are-released-in-philip-morris-v-australia-following-request-by-iareporter/.

ed financial model. It cost Crystallex $30 million USD to litigate the case.[154] In *Tethyan Copper v. Pakistan* the claimant spent $4.5 million USD on financial experts and $17.5 million USD on legal fees for the compensation phase of proceedings alone.[155] Pakistan spent almost $10 million USD defending the compensation phase, including both financial experts and legal fees.[156] Our proposal removes the complexity, expense and uncertainty associated with evaluation of the policy justifications for state conduct. It also simplifies the quantification of compensation by making compensation referrable to a past counter-factual, rather than a future counter-factual.

Third, there is an issue that has received less attention. Because existing jurisprudence on investment treaties maintains a sharp distinction between the treaties' substantive protections and the principles governing compensation, the application of existing treaties creates a "knife edge" of liability. A state that only just fails to meet the threshold set by existing substantive protections must pay full compensation, whereas a state that just satisfies the threshold pays nothing. This is a significant practical concern for states, given that the determination of whether state conduct breaches treaty protections like FET turns on *ex post* judgments that are difficult to predict in advance.[157] Other proposed modifications to the existing regime, such as the inclusion of exception provisions to clarify that certain forms of regulatory conduct are non-compensable, have the same "knife-edge" quality.[158] In contrast, compensation under our proposal varies according to the extent that the underlying structure of state conduct reflects the problem of time inconsistency.

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154. An unknown portion of this figure related to the quantification of compensation. Crystallex Int'l Corp. v. Bolivarian Republic of Venez., ICSID Case No. ARB(AF)/11/2, Award, ¶ 949 (Apr. 4, 2017), https://www.italaw.com/sites/default/files/case-documents/italaw7194.pdf.

155. Tethyan Copper Co. Pty Ltd. v. Islamic Republic of Pak., ICSID Case No. ARB/12/1, Award, ¶ 1824 (July 12, 2019), https://www.italaw.com/sites/default/files/case-documents/italaw10737.pdf.

156. *Id.* ¶ 1831.

157. For example, in the course of finding that Spain's alteration of the regulatory regime governing investment in solar energy breached the Energy Charter Treaty, that tribunal in 9REN specifically acknowledged that this outcome would have been uncertain for investors considering the issue prospectively. 9REN Holding S.à.r.l. v. Spain, ICSID Case No. ARB/15/15, Award, ¶ 412 (May 31, 2019), https://www.italaw.com/sites/default/files/case-documents/italaw10565.pdf. For a similar argument in a different context, see Susan Rose-Ackerman, *Against Ad Hocery: A Comment on Michelman*, 88 COLUM. L. REV. 1697, 1702–07 (1988).

158. For example, treaty annexes clarifying the concept of indirect expropriation, still require an ultimate judgement about whether there a measure amounts to indirect expropriation, in which case full compensation is required, or whether the measure does not amount to indirect expropriation, in which case no compensation is required. The same is also true of proposals for treaties to include clearly drafted exceptions provisions, such as van Aaken, *supra* note 21, at 526–27; Caroline Henckels, *Should Investment Treaties Contain Public Policy Exceptions?*, 59 B.C. L. REV. 2825, 2843 (2018).

For similar reasons, our proposal also addresses the three challenges with previous attempts at operationalizing the use/regulation distinction identified in Part III. Recall that Rubenfeld's and van Aaken's proposal are based on either/or characterizations of state conduct. Although we agree that there is a crucial conceptual distinction between time inconsistency (opportunism or use of property) and new information (regulation of property), we recognize that the two problems are often intertwined in complex factual scenarios. Our proposal is designed to avoid the challenges that come from having to characterize a particular instance of state conduct in an either/or way. This avoids related difficult evidentiary issues common both to existing jurisprudence and to other attempts to operationalize the use/regulation distinction.[159] For example, in a series of notorious disputes arising from changes made to the legal regime governing investment in the Argentinian gas industry following the Argentine financial crises in 2001, tribunals took different views on the extent to which such financial crises were foreseeable at the time that the investments were made.[160] Our proposal does not require a tribunal to determine the extent to which such crises were foreseeable. Rather, our rule is designed in such way that compensation is calibrated to provide redress only to the extent that a state's action is opportunistic, in an objective sense.

## V. Political Economy and Democratic Arguments for Our Proposal

Up to this point, we have taken the analysis of our companion paper as providing the foundational economic rationale for our proposal. The companion paper shows that, unlike well-known alternatives considered in the law and economics literature, our proposal guarantees improvements in both host and home state welfare compared to a situation in which there is no investment treaty. In order to keep concepts clear, the analysis of our companion paper is deliberately parsimonious. Alternative legal arrangements are evaluated solely according to their welfare effects, and the analysis of their

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159. Van Aaken proposes a different solution, whereby the challenges of verifying whether new information is genuinely "new" mean that the issue should be left to the state in question through the use of self-judging exceptions. van Aaken, *supra* note 21, at 526. The challenge with this solution is that a state that is acting opportunistically can also be expected to assert the applicability of available exceptions. Such a solution fails to provide protection to investment in those circumstances when it is needed most.

160. In CMS Gas v Argentina, Award, the tribunal held that the risk of financial crises leading to currency valuation were foreseeable and actually foreseen by the parties. CMS Gas Transmission Company v. The Republic of Argentina, ICSID Case No. ARB/01/8, Final Award, ¶ 225 (May 12, 2005) 44 I.L.M. 1205 (2005). In LG&E v Argentina, the tribunal took the view that the profound economic crisis in Argentina 2001-2002 went far beyond normal 'economic problems' or 'business cycle fluctuations' and threatened the total collapse of the Argentinian state. LG&E Energy Corp. v. Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability, ¶¶ 231–257 (Oct. 3, 2007) 46 I.L.M. 36 (2006).

welfare effects is based on an economic model that incorporates standard simplifying assumptions from the law and economics literature about the host state's decision-making. Specifically, the model in our companion paper is based on the assumptions that:

1. that the host state maximizes national welfare by weighing the impact of measures under consideration on various national constituencies accurately and equally; and
2. the host state is totally indifferent to the impact of its decisions on foreign investors.

These simplifying assumptions are not necessarily realistic and tend to overstate the need for the protection that investment treaties provide. In Part V.A below, we focus on problems with the first assumption, and their implications for our proposal. In Part V.B we examine problems with the second assumption, and their implications. Taken together, these sections show that integrating a more realistic account of government decision-making into our model further strengthens the case for our proposal over the status quo under investment treaties. In Part V.C, we suggest that investment treaties' implications for democratic decision-making should be considered. We argue there are strong democratic arguments for preferring our proposal to the status quo.

### A. *Our Proposal's Ability to Generate Global Welfare Improvement is Robust to Variation in Assumptions about the Host State's Decision-Making Function*

There is a large body of scholarship, spanning several disciplines, that suggests that government decision-making does not necessarily maximize national welfare. This body of scholarship includes work by political economists arguing that concentrated domestic interests tend to have greater influence on policy-making than diffuse interests;[161] work by political scientists on the extent to which politicians use control of the state apparatus to favor their own supporters;[162] work by sociologists on the role of policy elites in shaping state conduct;[163] and work by socio-legal scholars on how front-line bureaucrats make decisions within legal constraints.[164] As well as

161. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (Mancur Olson ed., 1965); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Gene M. Grossman & Elhanan Helpman, *Protection for Sale*, 84 AM. ECON. REV. 833 (1994).

162. *See* Andrew Harris & Daniel Posner, *(Under What Conditions) Do Politicians Reward Their Supporters? Evidence from Kenya's Constituencies Development Fund*, 113 AM. POL. SCI. REV. 123 (2019).

163. Janine Wedel, *From Power Elites to Influence Elites: Resetting Elite Studies for the 21st Century,* 34 THEORY CULTURE & SOC. 153 (2017).

164. Simon Halliday, Jonathan Ilan & Colin Scott, *The Public Management of Liability Risks*, 31 OXFORD J. LEGAL STUD. 527 (2011); Lael R. Keiser, *Understanding Street-Level*

raising doubts about whether government decision-making necessarily maximizes national welfare, this body of scholarship suggests that any single theory will struggle to account for the diversity in decision-making between various organs government across states that vary in their history, size, income and institutional arrangements.[165]

These concerns are particularly acute in the context of investment treaties for two reasons. First, investment treaties apply to a variety of states, both developed and developing; they apply to states with democratic forms of government, autocracies, and every other possible form of in between.[166] Second, investment treaties apply to the conduct of all state organs: national and sub-national levels of government, parliaments, presidents, ministers, and specialized regulatory agencies. Because the decision-making of different organs of government in different states can be expected to vary, it is important to consider how our proposal performs under diverse assumptions about government decision-making.

### 1. Investment Treaties as Applied to Government Actors that Ignore Them

We first consider a variation to our initial assumptions in which decision-makers within the state apparatus ignore the risk of liability under an investment treaty. This is a realistic model of government decision-making in at least in some circumstances. Empirical scholarship on the impact of investment treaties on government decision-making suggests a very low level of awareness of the constraints imposed by the treaties across governments in some developing countries.[167] In other cases, government decision-makers have been aware but apparently indifferent to the risk of liability under investment treaties, because the decision-maker adopting the measure

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*Bureaucrats' Decision Making: Determining Eligibility in the Social Security Disability Program* 70 PUB. ADM. REV. 247 (2010).

165. *See* David Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345 (2000).

166. Aside from a handful of micro-states, Brazil is the only state that is not bound by any investment treaties containing ISDS provisions. *Investment Dispute Settlement Navigator*, U.N. CONFERENCE ON TRADE & DEV., https://investmentpolicy.unctad.org/investment-dispute-settlement (last visited May 27, 2020).

167. MAVLUDA SATTOROVA, THE IMPACT OF INVESTMENT TREATY LAW ON HOST STATES (Hart Publishing, 1st ed. 2018); Emma Aisbett, Matthias Busse & Peter Nunnenkamp, *Bilateral Investment Treaties as Deterrents of Host-Country Discretion: The Impact of Investor-State Disputes on Foreign Direct Investment in Developing Countries* 154 REV. WORLD ECON. 119, 121–22 (2018); Jonathan Bonnitcha, *The Impact of Investment Treaties on Domestic Governance in Myanmar, in* INTERNATIONAL INVESTMENT TREATIES AND ARBITRATION ACROSS ASIA 335, 336–37 (Julien Chaisse & Luke Nottage eds., 2018) (on file with author).

did not bear the cost of paying compensation for breach of the investment treaty.[168]

When the host state ignores the risk of liability under an investment treaty, the treaties' global welfare impacts depend solely on their effect on foreign investors' decision-making.[169] An investor considering making an investment will consider the probability of adverse state conduct along with the amount of compensation it will receive in the event of such conduct and invest only if the project is expected to be profitable having taken into account these risks. Although our proposal does not reduce the likelihood of adverse state conduct, it does reduce the financial risk that opportunistic government conduct poses to the investor compared to a situation in which there is no investment treaty. This makes more projects under consideration profitable for the investor, and more investment occurs. As such, our rule creates benefits for investors. The increase in investment induced by our proposal also benefits the host state, regardless of whether the state ends up interfering with particular investments. This is because the principles governing compensation under our proposal ensure that, in the case of each and every investment, the host state can never be left worse off than if the investment were not made. As such, the Pareto improving, and hence global welfare improving, property of our rule is robust to the situation in which actual decision-makers within the government apparatus of the host state ignore the risk of having to pay compensation under investment treaties.

### 2. Investment Treaties and States That are Not Benevolent

As a second variation, we consider a situation in which the host state's decision-making function fully internalizes the costs and benefits of conduct under consideration to the state itself, but undervalues the effects of its conduct on other domestic constituencies. This variation inverts some of the assumptions of our first variation, yet is also is a realistic model of government decision-making in at least in some circumstances. It is consistent with scholarship that posits the existence of "fiscal illusion" in the state appa-

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168. In the case of *Metalclad v. Mexico*, the Governor of San Luis Potosi issued a decree preventing the investment from operating three days before the end of his term in office. In the case of *Abitibi Bowater v. Canada*, the province of Newfoundland and Labrador expropriated and refused to compensate the investor. The dispute was ultimately settled when the Canadian federal government stepped in to compensate the investor. Bertrand Marotte & John Ibbitson, *Provinces on Hook in Future Trade Disputes: Harper,* GLOBE & MAIL (Aug. 26, 2010), https://www.theglobeandmail.com/report-on-business/provinces-on-hook-in-future-trade-disputes-harper/article1378647/.

169. The payment of compensation (states will still have to pay compensation for breaching investment treaties, even if they ignore this risk in their decision-making) would also need to be taken into account in determining the impact on host state and investor welfare. The payment of compensation, however, has no net impact on global welfare expect through its *ex ante* effects on the behavior of various actors.

ratus,[170] and with theories of government decision-making in personalist dictatorships, in which the interests of the state are thought to be indistinguishable from those of the self-interested ruler.[171]

Relaxing the assumption that the host state fully values domestic constituencies' welfare does not affect the likelihood of opportunistic conduct in relation to foreign investments, as the risk of opportunism is driven by the host state's desire to capture benefits for itself. In contrast, the host state's predicted response to new information about the investment's impact on domestic constituencies—for example, social and environmental impacts—changes markedly. A host state which undervalues its own constituencies' welfare is substantially less likely to make inefficient changes to the domestic legal regime which seek to protect these constituents at the cost of the foreign investor.[172] In other words, under this variation to the assumptions there is more likely to be under-regulation than over-regulation of investment compared to the globally efficient level. This strengthens the justification for our proposal, which is designed to solve time inconsistency problems for the host state, not to change the way that the host state mediates between competing interests when responding to new information.

Let us now add an extra degree of realism and assume that the host state is also uncertain about the exact value of the welfare impact of the conduct under consideration for those constituencies—for example, because of the challenges in ascribing a dollar value to environmental harm to local communities.[173] (The same issue arises if the host state is certain about the value of these impacts, but uncertain about how the tribunal will value those impacts.)[174] This combination of fiscal illusion and uncertainty has serious im-

170. Blume and Rubinfeld define fiscal illusion as the assumption that the consequences of government decision-making "are generally discounted by the decision-making body unless they explicitly appear as a budgetary expense." Lawrence Blume & Daniel Rubinfeld, *Compensation for Taking: An Economic Analysis*, 72 CALIF. L. REV. 569, 621 (1984).

171. *See, e.g.,* Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567 (1993).

172. To illustrate, consider a state that is considering shutting down an investment in response to new information about environmental harm it causes to the local community. A state that fully internalizes the community's welfare will shut the investment down once the value of the environmental harm exceeds the fiscal benefit to the state of allowing the investment to continue to operate. A state that is indifferent to the interests of the local community will never shut a revenue-generating investment down, even if the state is also indifferent to investor's welfare.

173. Here, we are considering uncertainty on the part of the host government decision-maker at the time when it decides whether to change the domestic legal regime governing the investment. This goes beyond the assumptions about uncertainty made in our companion paper, which assumed that all parties are uncertain about the value of the external impacts of an investment at the time when that investment is made, but certain about the value of those impacts at the time at which the host state decides whether to respond by changing the domestic legal regime.

174. For consideration of more complex issues arising from asymmetric information and uncertainty on the part of arbitral tribunals, see, e.g., Emma Aisbett, Larry S. Karp & Carol

plications for existing jurisprudence, insofar as liability turns on a tribunal's judgment about the balance the state has struck between the foreign investor's interests and wider public interests. Given uncertainty about the value of costs and benefits associated with an investment to domestic constituencies, a government decision-maker considering how to respond to new information will be unsure whether altering the domestic legal regime will trigger liability under an investment treaty. Faced with this uncertainty, a government decision-maker who suffers from fiscal illusion will give greater weight to the risk of being required to compensate the investor than to the expected harm to domestic constituencies. This leads the decision-maker to be less willing to alter the domestic legal regime than is justified from a global efficiency perspective creating a sort of "regulatory chill."[175] This strengthens the argument for preferring our proposal to the status quo.

### B. *Our Proposal is Preferable from a Political Economy Perspective that Recognises the Possibility of Investor Lobbying and State Capture*

A related concern is the interaction between investment treaties' design and the political economy of investors' influence over the host state. These concerns arise from an agency problem. A state is an abstract legal entity, whereas the government officials who enter into legal arrangements on behalf of the state are individuals who may have private interests of their own. Corruption is the most extreme manifestation of this tension. For example, state officials may have private incentives to accept bribes in return for granting an investor a valuable concession contract. Other manifestations include the susceptibility of government officials to lobbying, political donations and other legal forms of influence, and the related tendency of investors to use these forms of influence to engage in rent-seeking. For example, an investor may lobby government officials to award it a long-term concession contract without a competitive tender, or cultivate personal relationships with government officials to obtain confidential information about plans for the privatization of state assets.[176] To be sure, these concerns are not specific to the relationship between *foreign* investors and host states.

McAusland, *Police Powers, Regulatory Taking And The Efficient Compensation Of Domestic And Foreign Investors*, 86 ECON. RECORD 367 (2010); JAN PETER SASSE, AN ECONOMIC ANALYSIS OF BILATERAL INVESTMENT TREATIES (U. Hamburg ed., 2011).

175. Emma Aisbett, A Welfare Economic View of International Investment Agreements, Address at OECD Freedom of Investment Roundtable (Oct. 17, 2015). Aisbett also makes the more general point that investment treaties as they are currently drafted and interpreted are likely to exacerbate inefficiency that results from states undervaluing the welfare of their own constituencies. *See also* Been & Beauvais, *supra* note 29, at 99.

176. Daniel R. Fischel & Alan Sykes, *Government Liability for Breach of Contract,* 1 AM. L. & ECON. REV. 313, 347 (1999).

But such allegations of impropriety are common in investment treaty arbitration.[177]

Before turning to the analysis of our proposal, there is an important threshold question: Whether foreign investments acquired through transactions that are not at arm's length are excluded from the coverage of investment treaties from the outset. Arbitral tribunals have consistently precluded foreign investors from invoking the protection of investment treaties if an investment was acquired corruptly.[178] Many tribunals have also held investment treaties do not protect investments made in clear contravention of the law of the host state as it stood at the time the investment was made,[179] although jurisprudence on this point is more equivocal.

What is clear is that investments that are acquired through forms of influence that are legal or arguably legal under the law of the host state are entitled to the protection of investment treaties.[180] For example, in *Sanum v. Laos* the investor acquired a majority stake in valuable monopoly concessions to operate casinos in Laos near the border with China. The concessions were acquired through a series of related agreements with the Lao state and a private Lao entity.[181] Information contained in the award suggests that the investor paid as little as $3.5 million USD for the concessions,[182]

177. An example of case in which these allegations were made is Hussain Sajwani, Damac Park Ave. for Real Est. Dev. S.A.E. v. Arab Republic of Egypt, ICSID Case No. ARB /11/16, Procedural Order (Sept. 10, 2014), discussed in Jonathan Bonnitcha, *Investment Treaties and Transition from Authoritarian Rule* 15 J. WORLD INV. TRADE 965, 982 (2014); Chris Hamby, *Inside the Global "Club" That Helps Executives Escape their Crime*, BUZZFEED NEWS (Aug. 28, 2016). The case ultimately settled.

178. Metal-Tech Ltd. v. Republic of Uzbekistan, ICSID Case No. ARB/10/3, Award, ¶ 110 (Oct. 4, 2013), https://www.italaw.com/sites/default/files/case-documents/italaw3012.pdf; Andrea Menaker, *The Determinative Impact of Fraud and Corruption on Investment Arbitrations*, 25 ICSID REV. 67, 69 (2010).

179. *See, e.g.*, Vladislav Kim v. Republic of Uzbekistan, ICSID Case No. ARB/13/6, Decision on Jurisdiction, ¶¶ 394–404 (Mar. 8, 2017), https://www.italaw.com/sites/default /files/case-documents/italaw8549.pdf; Plama Consortium Ltd v. Republic of Bulgaria, ICSID Case No. ARB/03/24, Award, ¶ 135 (Aug. 27, 2008), 17 ICSID Rep. 659 (2016); Phoenix Action, Ltd v. Czech Republic, ICSID Case No. ARB/06/5, Award, ¶ 101 (Apr. 15, 2009), https://www.italaw.com/sites/default/files/case-documents/ita0668.pdf; Stephan Schill, *Illegal Investments in Investment Treaty Arbitration* 11 L. & PRAC. INT'L CTS & TRIBUNALS 281, 322–23 (2012); Bonnitcha, *supra* note 177.

180. Another example is the case of Unión Fenosa Gas, S.A. v. Arab Republic of Egypt. Here, the tribunal held that the investor was entitled to the protection of the investment treaty, notwithstanding the fact that it had exercised "influence. . . over senior decision-makers at the Ministry of Petroleum and EGPC [the Egyptian General Petroleum Company]" in procuring the investment contract. Unión Fenosa Gas, S.A. v. Arab Republic of Egypt, ICSID Case No. ARB/14/4, Award of the Tribunal, ¶ 7.109 (Aug. 31, 2018), https://www.italaw.com/sites /default/files/case-documents/italaw10061.pdf.

181. Sanum Investments Ltd. v. Lao People's Democratic Republic, PCA Case No. 2013-13, Award on Jurisdiction, ¶ 33 (Dec. 13, 2013), https://www.italaw.com/sites/default /files/case-documents/italaw3322.pdf.

182. *Id.* ¶ 24

plus an additional contribution to financing the development of the casinos.[183] These amounts are surprisingly low, given that the casinos proved lucrative.[184] Laos did not allege corruption or illegality in the acquisition of the investment in these proceedings.[185] It did, however, draw attention to the apparent discrepancy between the amount invested by the claimant and the value of rights thereby acquired, and argued that the investment should not be eligible for the protection of the treaty.[186] The tribunal rejected these arguments on the basis that the protection of the treaty depended on the validity of the rights acquired, not the amounts involved in the transactions.[187] In the analysis that follows we take this position—that foreign investment is not automatically excluded from the protection of an investment treaty because it was acquired below market value, or through a non-arm's length transaction—as given.

In this context, there are two ways in which investment treaties interact with the political economy of corporate influence over government decision-making.[188] First, investment treaties increase the return to rent-seeking behavior in the making of new investments. In the absence of an investment treaty, a foreign investor who obtains privatized state assets or concession rights through non-arm's length transactions is vulnerable to revocation or renationalization. Investment treaties make rent-seeking a more attractive strategy by conferring legal protection on these ill-gotten gains. The second dynamic runs counter to the first. In the absence of an investment treaty, investors are more vulnerable to adverse conduct of the state over the lifespan of the investment. As such, investors have a financial incentive to cultivate and exercise influence over the host state to maintain the value of their investment. By conferring legal protection on foreign investment, investment treaties reduce the need for this ongoing rent-seeking behavior after the investment is made.

So far as we are aware, investment treaties' impact on the prevalence of both forms of rent-seeking has not been investigated empirically to date. Instead, we consider the implications of the design of investment treaties for

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183. The latter figure was estimated at around $65 million USD by the respondent and as at least $85 million USD by the claimant. *Id.* ¶¶ 40, 140.

184. *Id.* ¶ 40.

185. In parallel proceedings brought by the investor's parent company under a different investment treaty, Laos has subsequently alleged corruption on the part of the investor. These allegations have not been proven and it is unclear whether they relate to the acquisition of the investment. Lao Holdings N.V. v. The Lao People's Democratic Republic, ICSID Case No. ARB(AF)/12/6, Procedural Order No. 11 (Jun. 25, 2018), https://www.italaw.com/sites/default/files/case-documents/italaw9767_0.pdf.

186. Sanum Investments Limited v. Lao People's Democratic Republic, PCA Case No. 2013-13, Award on Jurisdiction, ¶¶ 40, 131–136 (Dec. 13, 2013), https://www.italaw.com/sites/default/files/case-documents/italaw3322.pdf.

187. *Id.* ¶¶ 316–321

188. Fischel & Sykes, *supra* note 176, at 342.

both dynamics, focusing on a comparison between our proposal and the status quo. We use the simple example of outright expropriation as an illustration. The same tension plays out in a similar way across more complex fact scenarios.

Under the status quo, a foreign investor is entitled to full market value compensation for expropriation, even if the investment was originally acquired from the state for much less than its market value. In this way existing investment treaties increase investors' incentive to engage in rent-seeking in the acquisition of investments, compared to the situation in which there is no investment treaty. In contrast, under our proposal a foreign investor's entitlement to compensation for expropriation is, at most, the price originally paid for the investment. An investor that uses influence over government officials to obtain a state's assets below their market value will find that its entitlement to compensation in the event of subsequent renationalization of those assets is also reduced. (One situation in which this fact pattern arises is when there is a transition from an authoritarian to a more democratic regime in a state, and the incoming regime seeks to recover assets transferred to cronies of the former regime.)[189] As such, our proposal does not substantially increase investors' incentive to engage in rent-seeking behavior in the acquisition of investments, compared to the situation in which there is no investment treaty.

By guaranteeing some compensation for expropriation, our proposal also reduces investors' incentive to engage in rent-seeking throughout the lifespan of the investment, compared to the situation in which there is no investment treaty. However, because compensation under our proposal is inevitably less than the expected value of the unexpropriated investment to the investor, there remains some incentive to engage in ongoing rent-seeking. In contrast, the status quo eliminates investors' incentive to engage in rent-seeking throughout the lifespan of the investment, because any expropriation must be accompanied by compensation equivalent to the expected value of the investment.

Although both forms of rent-seeking behavior are socially wasteful and undermine domestic investment governance, there are good reasons to design legal rules to minimize investors' incentive to engage in the former, rather than the latter. Following Fischel and Sykes, our argument is based on the uncertainties of government decision-making within host states.[190] Where the benefits of rent-seeking behavior are more certain, we should expect rational investors to engage in such behavior. Rent-seeking relating to the acquisition of investment involves a single time-period. Under investment treaties as they are currently drafted, once an investment is acquired through a non-arm's length transaction the benefits of such behavior are secured for the duration of the investment. This creates an incentive for large

189. Bonnitcha, *supra* note 177, at 985.

190. Fischel & Sykes, *supra* note 176, at 343.

expenditures on rent-seeking. In contrast, an investor considering engaging in rent-seeking throughout the lifespan of an investment is always vulnerable to a change of government or public sentiment at a subsequent date. (Indeed, it may be that investors who are perceived to have benefited from cozy relationships with government officials are more vulnerable to backlash in the medium term.) The inherent uncertainty about the effectiveness of ongoing rent-seeking as a strategy reduces the benefit to investors of engaging in it, even in the absence of an investment treaty. For this reason, further reducing the incentive for investors to engage in such behavior should not be a primary consideration in the design of investment treaties' substantive protections. Instead, our proposal should be preferred to the status quo because it does not create incentives for investors to engage in rent-seeking in the acquisition of investments.

### C. *Our Proposal is Preferable from a Democratic Perspective*

Investment treaties constrain the conduct of the state. This inevitably raises questions about their interaction with democratic decision-making.[191] To be sure, not *every* state that is bound by an investment treaty is a democracy.[192] But investment treaty claims against democracies are far more common than the investment treaties' proponents seem to assume.[193] Understanding investment treaties' interaction with democratic decision-making also has at least some relevance to wider questions about their relationship with responsive governance in non-democratic states or state that are only partially democratic.[194]

Concerns about investment treaties' intersection with democracy have two dimensions. The first concerns the process by which the treaties were adopted, including whether the content of the treaties was understood by the

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191. Martti Koskenniemi, *It's Not the Cases. It's the System.: M. Sornarajah, Resistance and Change in the International Law on Foreign Investment*, 18 J. WORLD INV. & TRADE 343, 347 (2017) (characterizing investment treaties as embodying a particular set of beliefs about the relationship between democracy and economic governance); *see also* Rose-Ackerman, *supra* note 157, at 1702 (suggesting that the central challenge in designing constitutional principles that protect private property from adverse government action is "to reconcile an unpredictable, democratically responsible polity with the existence of a capitalist economy based on private property and individual initiative.").

192. *See* José E. Alvarez, *Review: Investment Treaty Arbitration and Public Law by Gus van Harten*, 102 AM. J. INT'L L. 909 (2008).

193. For example, Jan Paulsson has written that "a country governed in accordance with the rule of law has little to fear from BITs." Jan Paulsson, *Moral Hazard in International Dispute Resolution,* 25 ICSID REV. 339, 347 (2010). But, in important empirical work, Williams shows that democracies are more likely to be subject to claims under investment treaties than non-democratic states even after controlling for other variables, such as inbound FDI stock. *See* Zoe Philipps Williams, *Risky Business or Risky Politics: What Explains Investor–State Disputes?* (2016) (Ph.D. dissertation, Hertie School of Governance) (on file with author).

194. For example, in non-democratic states some agencies of government may nevertheless be sensitive to public opinion.

public and whether the treaties were subject to appropriate parliamentary scrutiny. Up until at least the end of the 1990s, most investment treaties were adopted with minimal parliamentary scrutiny or public debate.[195] Indeed, in many developing countries even those who negotiated investment treaties did not fully appreciate their legal implications.[196] The majority of investment treaties in existence today date from this period. The lack of democratic deliberation in their negotiation is not an argument in favor of our proposal specifically, but it does raise questions about the democratic legitimacy of the status quo.[197]

Since the explosion of arbitrations in the mid-2000s, investment treaty-making has been subject to greater public scrutiny. For example, the U.S. held public consultations prior to the revision of its model BIT in 2004. Likewise, in 2014 the European Commission conducted public consultations on the inclusion of investment provisions in the Transatlantic Trade and Investment Partnership. Investment treaties have also been discussed extensively in the European Parliament.[198]

Following a controversial challenge to its black economic empowerment policies, South Africa launched a three year review of its investment policy regime, leading to a cabinet decision to terminate its entire stock of investment treaties.[199] Many other states have been reconsidering their approach to investment treaties, including Australia, Colombia, India, Indonesia, Morocco and Nigeria.[200] Two observations can be made about this trend to wider public deliberation and debate about investment treaties in recent years: first, almost all such processes of deliberation have resulted in recommendations for change of the status quo and, second, that such changes range from minor reform (in the case of the 2004 U.S. model BIT) to total exit from the existing regime (in the case of South Africa). The picture that emerges is not one of consensus between states on the desirability of the status quo, rather it is one of uncertainty and disagreement about the distribution of costs and benefits of existing investment treaties.

In this context, there is a strong democratic justification for our choice of the Pareto criterion as the primary basis for evaluation of investment trea-

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195. LAUGE POULSEN, BOUNDED RATIONALITY AND ECONOMIC DIPLOMACY: THE POLITICS OF INVESTMENT TREATIES IN DEVELOPING COUNTRIES 14–15 (Cambridge Univ. Press, 2015).

196. *See id.*

197. MONTT, *supra* note 36, at 141–44. *See also* Been & Beauvais, *supra* note 29, at 137–38.

198. *E.g.,* European Union, Council Regulation No. 912/204, Recital 4., 2014 O.J. (L257) 21. The EU is now proposing a new Multilateral Investment Court to replace ad hoc arbitration of investment treaty disputes. We discuss the relationship between our proposal and these developments *infra* Part VI.

199. Mohammed Mossallam, *Process Matters: South Africa's Experience Exiting its BITs* 3 (GEG, Working Paper No. 2015/97, 2015).

200. Morosini & Sanchez Badin, *supra* note 22.

ties' provision. A minimum requirement for a democratic state to enter into treaties should be that the treaty increases national welfare.[201] This limits the range of possible treaties between democracies to those that improve the welfare of all state parties—i.e. the Pareto criterion. Our companion paper shows that, unlike alternatives that approximate the level of protection currently provided by investment treaties, our proposal meets this criterion.

The second dimension of investment treaties' intersection with democracy relates to the constraints the treaties place on host states once in force.[202] Investment treaties allow foreign investors to demand compensation for new legislation passed by democratically elected parliaments and for exercise of administrative power that elected officials validly delegate to agencies.[203] It is no defense for a host to argue that it enacted the measure in question according to a democratic process.

In this simple sense, investment treaties clearly constrain democratic decision-making in the states that are bound by them. (The same could be said of any international treaty backed by a binding dispute settlement system.) The extent of this constraint depends on the extent of protection from legal and policy change that the treaties give to foreign investors. Our proposal places a lesser constraint on states than the status quo, both because much government conduct for which compensation is currently required would not be compensable under our proposal and because, insofar as compensation is required under our proposal, the amount would generally be less than is the case under the status quo.

But there is another, more precise, sense in which investment treaties constrain democratic decision-making. An essential characteristic of democratic governance is reversibility.[204] A government may adopt particular laws and policies. If members of the public oppose those laws and policies, they are entitled to campaign against them. If enough members of the public agree, a new government may be elected on a platform to alter what previously may have been regarded as settled. This basic process of contestation and revision of the domestic legal regime is a normal and healthy part of the democratic process. It is reflected in the foundational constitutional princi-

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201. Similarly, Kurtz, arguing that treaties are legitimate from a democratic perspective if adopted through democratic processes and necessary to achieve instrumental benefits arising from international cooperation. Jürgen Kurtz, *Building Legitimacy Through Interpretation in Investor-State Arbitration: On Consistency, Coherence, and the Identification of Applicable Law*, *in* THE FOUNDATIONS OF INTERNATIONAL INVESTMENT LAW: BRINGING THEORY INTO PRACTICE 257 (Zachery Douglas, Joost Pauwelyn, & Jorge E. Viñuales eds., 2014).

202. DAVID SCHNEIDERMAN, CONSTITUTIONALIZING ECONOMIC GLOBALIZATION: INVESTMENT RULES AND DEMOCRACY'S PROMISE (2008); MONTT, *supra* note 36, at 169–77.

203. BONNITCHA ET AL., *supra* note 1, at 235.

204. David Schneiderman, *Against Constitutional Excess: Tocquevillian Reflections on International Investment Law*, 85 U. CHI. L. REV. 585 (2018).

ple that "one legislature may not bind the legislative authority of its successors."[205]

Investment treaties, as they are currently drafted and interpreted, impose significant constraints on this process of democratic contestation. These constraints are most obvious in the protection of foreign investors' legitimate expectations—expectations that a state will continue to act consistently with assurances, policies, and laws in place when an investment was made for the entire lifespan of the investment.[206] In contrast, our proposal does not require compensation for a change in political priorities as such, which fall within our conception of new information. A host state is only liable if it has gained from not having had the new domestic legal regime in place from the outset, and the most it could be required to pay in compensation is the value of the gain. In other words, under our proposal the host state cannot end up worse off than if it had had the new legal regime in place from the outset. While there are still consequences for legal and policy shifts under our proposal, it does not constrain democratic choice in the sense that it doesn't penalize a state for legal and policy reversals.

To illustrate, consider an example where a state approves an investor's mining project in a national park. The state is aware that the project will have a negative environmental impact but decides that the economic development flowing from the proposal will outweigh this impact. An opposition party opposes this decision on the grounds that the project's environmental impact outweighs its economic benefits. It campaigns on the platform of introducing a moratorium on mining in the national park, wins the election and cancels the project. Under the status quo, this policy reversal triggers a requirement to pay compensation equal to the expected value of the mine had it been allowed to continue operation. Under our proposal, the state cannot be left worse off than if it had had the moratorium in place from the outset; at most, it will have to refund any gain it has made from allowing the project, such as the price for which it sold the concession to the investor.

## VI. The Relationship Between Our Proposal and Discussions in UNCITRAL Working Group III on Investor-state Dispute Settlement Reform

In the foregoing sections, we have made the case for a new approach to liability and compensation under investment treaties. This leaves the question of how our proposal could be implemented as a practical matter. As we have explained,[207] existing principles governing liability and compensation

205. United States v. Winstar Corp., 518 U.S. 839, 872 (1996). This is sometimes called the rule against entrenchment. For discussion, see Eric A. Posner & Adrian Vermeule, *Legislative Entrenchment: A Reappraisal*, 111 YALE L.J. 1665 (2002).

206. For further discussion, *see supra* Section IV.a.1.

207. *See supra* Section IV.a.

under investment treaties emerge from the combination of the treaties' express provisions and the accretion of arbitral jurisprudence relating to the interpretation of those provisions. In theory, some aspects of our proposal could be implemented in a decentralized way by arbitral tribunals themselves, through shifts in the interpretation of existing treaty provisions. For example, tribunals might reconsider the justifications for protecting investors' expectations under the FET standard, or for awarding investors compensation based on projections decades into the future of the income that an investment project would have earned. However, arbitral tribunals' practice of relying on the decisions of past tribunals as authority mean that significant shifts in jurisprudence are unlikely in the absence of state intervention.[208] And other aspects of our proposal—notably, the integration of gained-based considerations into the assessment of compensation—could only be implemented through the amendment of existing investment treaties.[209] Many states are currently reconsidering their existing treaty practice. In this context, our proposal provides a basis for the amendment of existing treaties and for the negotiation and drafting of new investment treaties in the future.

Our proposal also has implications for the multilateral discussions about the reform of investment treaties' investor-state dispute mechanism currently underway in UNCITRAL Working Group III.[210] The UNCITRAL Working Group's mandate was originally defined narrowly, to prevent disagreements about the substantive content of investment treaties from derailing attempts to find agreement on reform of the arbitration process.[211] The EU's

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208. Anthea Roberts, *Power and Persuasion in Investment Treaty Interpretation: The Dual Role of States* 104 AM. J. INT'L L. 179, 190 (2010). For an empirical analysis, see Wolfgang Alschner, *Ensuring Correctness or Promoting Consistency? Tracking Policy Priorities in Investment Arbitration Through Large-Scale Citation Analysis*, *in* EMPIRICAL PERSPECTIVES ON INVESTMENT ARBITRATION 1 (Daniel Behn, Ole Kristian Fauchald & Malcolm Langford eds., 2019).

209. *See* Roberts, *supra* note 208 (arguing that states have the power to amend treaties, including to the detriment of investors).

210. For commentary on the process, see Anthea Roberts, *Blog of the European Journal of International Law*, EJIL: TALK!, https://www.ejiltalk.org/author/aroberts/ (last visited Mar. 25, 2021).

211. In 2017, the Working Group agreed to proceed with its work in three stages, "(i) first, identify and consider concerns regarding ISDS; (ii) second, consider whether reform was desirable in light of any identified concerns; and (iii) third, if the Working Group were to conclude that reform was desirable, develop any relevant solutions to be recommended to the Commission." U.N. Comm'n on Int'l L. & Trade, Rep. of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-Fourth Session, U.N. Doc. A/CN.9/930 /Rev.1 3 (Dec. 19, 2017).

In 2018, the Working Group stated the concerns which had identified, which were group under three headings:

A. Concerns pertaining to the lack of consistency, coherence, predictability and correctness of arbitral decisions by ISDS tribunals

proposal to establish a new multilateral investment court has been a focal point for these debates about reform of the ISDS mechanism.[212]

The original definition of the Working Group's mandate overlooks the many ways in which procedural concerns relating to ISDS as an adjudicative mechanism and substantive concerns relating to the liability and compensation under investment treaties are intertwined. Consider, for example, the EU's proposal for a multilateral investment court. The decisions of such a court would have greater legitimacy than those rendered by arbitral tribunals; doctrinal principles established or endorsed by such a court would then be difficult to revisit. The potential for a multilateral investment court to endorse and legitimize existing jurisprudence on compensation and damages is particularly concerning. Existing principles governing damages under investment treaties are largely a creation of arbitral doctrine. If debate about compensation and damages under investment treaties were deferred until after the conclusion of the UNCITRAL process, there is a real risk that a newly created multilateral investment court will already have "locked in" the existing approach to damages.

In response to these concerns, several states have argued for a broadening of the Working Group's mandate.[213] In particular, in the October 2019 session, both Nigeria and Pakistan argued successfully for the addition of compensation and damages under investment treaties to the Working Group's agenda as a "cross-cutting" issue.[214] Our proposal speaks directly to

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B. Concerns pertaining to arbitrators and decision makers

C. Concerns pertaining to cost and duration of ISDS cases

*See* U.N. Comm'n on Int'l L. & Trade, Report of Working Group III (Investor-State Dispute Settlement Reform) on the Work of its Thirty-Sixth Session, U.N. Doc. A/CN.9/964 6, 11, 16 (Nov. 6, 2018).

This framing has then been reflected in the questions addressed by the academic working group. For criticism, see *Open Letter on the Asymmetry of ISDS*, ERASMUS INST. PUB. KNOWLEDGE, https://www.eur.nl/en/news/erasmus-institute-public-knowledge (last visited Jun. 25, 2020).

212. Anthea Roberts, *Incremental, Systemic and Paradigmatic Reform of Investor-State Arbitration* 112 AM. J. INT'L L. 410 (2018). For the substance of the EU proposal, see generally U.N. Comm'n. on Int'l Trade L., Report of Working Group III on its Thirty-Seventh Session, U.N. Doc. A/CN.9/WG.III/WP.159/Add.1 (Jan. 18, 2019), https://trade.ec.europa.eu/doclib/docs/2019/january/tradoc_157631.pdf.

213. Anthea Roberts & Taylor St. John, *UNCITRAL and ISDS Reform: Visualising a Flexible Framework*, EJIL: TALK! (Oct. 24, 2019), https://www.ejiltalk.org/uncitral-and-isds-reform-visualising-a-flexible-framework/ (citing the submissions by Indonesia, Bahrain, Thailand, South Africa and various NGOs).

214. On Pakistan and Nigeria's intervention, see Anthea Roberts & Taylor St. John, *UNCITRAL and ISDS Reform: In Sickness and In Health*, EJIL: TALK! (Oct. 23, 2019), https://www.ejiltalk.org/uncitral-and-isds-reform-in-sickness-and-in-health/. On the revised agenda, see U.N. Comm'n on Int'l Trade L., Report of Working Group III (Investor-State Dispute Set-

the issue, and provides a principled approach to addressing concerns about out-size awards under existing jurisprudence. As of mid-2020, the Working Group is considering modalities for reform, with attention being given to the possibility of a multilateral instrument containing a menu of various reform options. States that became party to such an instrument could then give their consent to "opt in" to specific reforms.[215] If two states "opt in" to the same reforms, the effect would be to amend any bilateral investment treaty between those states to incorporate the reform in question. In this way, a multilateral instrument can avoid the practical problems that would arise from states having to negotiate the amendment of thousands of investment treaties one-by-one, while accommodating the fact that different states may be inclined to move at different speeds on different reform options. Such a multilateral instrument could include substantive reforms to the content of underlying investment treaties, as well as reforms to the ISDS process.[216] Our proposal is well-suited to inclusion in such an instrument, particularly insofar as it addresses the principles governing compensation and damages under investment treaties. The multilateral instrument that will likely emerge from the UNCITRAL Working Group is the most promising means by which our proposal could be implemented in practice.

To facilitate the inclusion of our proposal, insofar as it relates to the principles governing compensation and damages, in such a multilateral instrument it is important to translate it into legal text that is as prescriptive as possible, to reduce the risk of misunderstanding by tribunals that may not appreciate the underlying economic and policy rationales for our approach. With this in mind, we propose the following text:

(1) To determine the amount of compensation due for expropriation or for any other measure(s) that breach(es) this treaty, the tribunal shall first determine whether, if the measure(s) had been in place immediately prior to the time at which the investor made its investment, the investor would, nevertheless, have made the investment:

   a. To determine whether the investor would have made the investment, the tribunal shall consider objective rather than subjective factors. In particular, the tribunal shall base its decision on whether, if the measure(s) had been in place immediately

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tlement Reform) on the Work of its Thirty-Eighth Session, U.N. Doc A/CN.9/1004* (Oct. 23, 2019).

215. *See* U.N. Comm'n on Int'l Trade L., Possible Reform of Investor-State Dispute Settlement (ISDS) Multilateral Instrument on ISDS Reform: Note by the Secretariat, U.N. Doc A /CN.9/WG.III/WP.194, ¶¶ 8–9 (Jan. 16, 2020). For academic discussion, see Wolfgang Alschner, *The OECD Multilateral Tax Instrument: A Model for Reforming The International Investment Regime?*, 45 BROOK. J. INT'L L. 1 (2019); Stephan W. Schill & Geraldo Vidigal, *Designing Investment Dispute Settlement à la Carte: Insights from Comparative Institutional Design Analysis*, 18 L. & PRAC. INT'L CTS. & TRIBS. 314 (2019).

216. Roberts & St. John, *supra* note 214.

prior to the time at which the investor made its investment (but if the situation in all other respects, including information about the likelihood of future contingencies, was the same as that facing the investor immediately prior to making its investment), the investment would, nevertheless, have been expected to generate a positive net return.

b. In the case of measure(s) amounting to expropriation of an investment, a tribunal shall conclude that the investor would not have made the investment if the measure(s) had been in place immediately prior to the time at which the investor made its investment, unless the host state proves otherwise.

(2) If the tribunal determines that the investor would have made the investment, then no compensation is due to the investor.

(3) If the tribunal determines that the investor would not have made the investment, then the tribunal shall award the lesser of the following amounts as compensation to the investor:

a. The value of the loss the investor has suffered, as compared to the situation the investor would have been in if it had not made the investment; and

b. The value of the gain the host state has obtained, as compared to the situation the host state would have been in if the investor had not made the investment.

i. In assessing the value of 3(b) the tribunal shall take into account any payment the investor has made to the host state to acquire the investment, any physical assets owned by the investor that have been transferred into state ownership and any genuinely additive economic contribution of the investment to the host state's economy—for example, through the payment of wages to employees in the host state at a higher rate than the wages those employees would have earned if the investment had not been made. In assessing the value of 3(b) the tribunal shall deduct the value of any damage caused by the investment's operation to the host state.

By implication of the above, when either amount 3(a) or 3(b) is zero, compensation shall be zero.

This language could also be incorporated into new treaties and into existing treaties by way of an agreement to amend the treaty among the parties to it.

## VII. CONCLUSION

Investment treaties are highly unusual instruments of international law. They provide a particular class of private actors—foreign investors—with internationalized legal protection from state conduct, as well as a procedural mechanism to enforce these rights. No other regime of international law provides analogous protection to private actors.[217] The existence and design of these special privileges for foreign investors must be carefully justified. In a companion paper we argue that, while there is an underlying economic rationale for investment treaties, that rationale is more limited than lawyers seem to assume. Investment treaties should seek to solve problems of time inconsistency for the host state but should not seek to constrain the way that states respond to new information. In this article, we explored the implications of this insight for the extent of substantive protection and the principles governing compensation under investment treaties.

We proposed that investment treaties should be redrafted so that:

i. A state should only face the possibility of having to compensate a foreign investor if the host state breaches or modifies the domestic legal regime governing the investment, and

ii. Compensation should be the lesser of the investor's loss and the host state's gain from the host state not having had the new domestic legal regime in place when the investment was made. (When one or other of these values is zero, no compensation is required.)

In Part VI, we propose more detailed draft treaty text that explains how compensation under the second limb of this proposal should be determined in a step-by-step manner.

Key practical implications of our proposal are that states should not be required to compensate investors in many of the circumstances that are compensable under existing investment treaty jurisprudence and that, insofar as compensation is required, the amount of compensation will ordinarily be less than is currently the case. Another distinguishing feature of our proposal is that it does not require arbitral tribunals to weigh or balance com-

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217. Regional regimes for human rights protection—such as the European Convention of Human Rights—are a partial exception. *See* BONNITCHA, ET AL., *supra* note 1, at 65. But even such regimes do not go so far as the investment treaty regime. A claimant to the European Court of Human Rights must first exhaust domestic remedies before bringing an international claim against a state. Exhaustion of domestic remedies is not required under investment treaties. *See* Douglas, *supra* note 93, at 179. Moreover, the European Court of Human Right's jurisprudence on compensation for victims requires only "just satisfaction," a much less generous standard than the principle of "full reparation" applied in the investment treaty regime. *See* Veronika Fikfak, *Changing State Behaviour: Damages before the European Court of Human Rights*, 29 EUR. J. INT'L L. 1091, 1107 (2019).

peting interests in order to determine whether compensation is required or, insofar as compensation is required, to determine the amount that should be paid.

In Part III, we showed that this proposal builds on a line of scholarship that distinguishes government *use* (or acquisition, or appropriation) of property from government *regulation* of private property. In Part IV we explained how our proposal resolves previous attempts to develop jurisprudence based on the use/regulation distinction. Part IV also argued that, by eschewing the use of balancing techniques to determine whether the host state has breached an investment treaty, our proposal solves many of the practical problems with existing jurisprudence relating to the interpretation and application of investment treaties. Taken together, Parts III and IV illustrate that our proposal is feasible and that it relies on information and legal techniques that are available and familiar to arbitral tribunals.

Part V explored some of the wider policy arguments in favor of our proposal. We showed that the ability of our proposal to generate welfare benefits for both host and home states is robust to realistic variations in assumptions about government decision-making. We also considered the risk of more serious pathologies in government decision-making, such as susceptibility to lobbying and capture by foreign investors. Finally, we argued that there are strong democratic arguments for preferring our proposal to the status quo. Taken together, the arguments in Part V strengthen our central claim that our proposal is superior to the status quo.

Part VI considered the implementation of our proposal as a practical matter and, in particular, the relationship between our proposal and the multilateral discussion on reform of the investment treaty regime currently underway in UNCITRAL Working Group III. In 2019, concerns about compensation and damages under investment treaties were added to the Working Group's agenda, demonstrating that reform in this area is a high priority for states. As to the modalities of reform, the Working Group is considering a multilateral instrument that would include a menu of procedural and substantive reforms. States that become party to such an instrument could then give their consent to "opt in" to specific reforms. Our proposal is well-suited to inclusion in such an instrument.