



**IILJ International Legal Theory Colloquium Spring 2009:
Virtues, Vices, Human Behavior and Democracy in International Law**

Benedict Kingsbury and Joseph Weiler
NYU Law School

Pollack Colloquium Room, Furman Hall 9th Floor, 245 Sullivan Street
Thursdays 4pm-5.50pm

[student seminar also meets separately, Tuesdays 4pm-5.50pm]

Note: speakers' topics listed are indicative of areas, not final titles, and may change

- January 15** - Derek Jinks, University of Texas Law School
Topic: *Humanization and Individualization in the Enforcement of International Humanitarian Law*
- January 22** - **Anne van Aaken, University of St Gallen Law School, Switzerland**
Topic: ***International Investment Law and Rationalist Contract Theory***
- January 29** - Craig Calhoun, NYU Institute for Public Knowledge & President, SSRC
Topic: *Humanitarian Action in Cosmopolitan Perspective*
- February 5** - Paolo Carozza, Notre Dame Law School and Chair, IACmHR
Topic: *Local Freedom, Human Rights, and International Law: A Tocquevillian Approach*
- February 12** - Leigh Payne, Oxford University Sociology (Latin American Societies)
Topic: *Neither Truth Nor Reconciliation in Confessions of State Violence: Unsettling Accounts and Colombia's Justice and Peace Law*
- February 26** - William Miller, University of Michigan Law School
Topic: *Messengers and Intermediaries: Insights from Ancient Law*
- March 5** - Moshe Halbertal, NYU Law School and Hebrew University
Topic: *Pre-Conditions for Forgiveness*
- March 12** - Joseph Weiler, NYU Law School
Topic: *Europe Against Itself: On the Distinction between Values and Virtues (and Vices) in the Construction and Development of European Integration*
- March 26** - Armin von Bogdandy, NYU Law School, Director MPI Heidelberg
Topic: *Problems of International Public Authority*
- April 2** - Pierre Rosanvallon, Collège de France
Topic: *The Metamorphoses of Democratic Legitimacy*
- Tuesday, April 7**- (SPECIAL SESSION, 4:00 pm to 5:50 pm)
Faculty Club, D'Agostino Hall, 110 West 3rd Street
Alexander Somek, University of Iowa
Topic: *Democracy-Enhancing International Law: The Argument for Transnational Effect*
- April 16** - Conference in Honor of Professor Andreas Lowenfeld
(For more information, go to www.iilj.org – all welcome!)
- April 23** - Martha Nussbaum, University of Chicago Law School
Topic: *Patriotism*

Program and papers available at: <http://iilj.org/courses/2009IILJColloquium.asp>

International Investment Law and Rationalist Contract Theory

Anne van Aaken *

Working Paper, to be presented at NYU, 22 January 2009

This article analyzes international investment protection law by using tools of economic contract theory. Contract theory has been applied to international trade law, but investment law has not yet been analyzed under this methodology. International Investment Agreements may be interpreted as a mechanism for overcoming commitment problems between investor and host state in order to generate mutual benefits. States trade credibility for sovereignty as international investment law restricts the regulatory conduct of states to an unusual extent, subject to control through compulsory international adjudication. A well-known problem in contract theory is how to deal with uncertainty. Changing conditions are a prevalent characteristic in investment law. Contract theory finds that too strict and inflexible contracts may impair the joint surplus of the contracting parties. Thus, a trade-off arises between *ex ante* commitment on the one hand and flexibility *ex post* in order to uphold the efficiency of the contract on the other. Those problems become virulent in unforeseen crises, such as financial or economic ones. This article analyzes commitment and flexibility mechanisms in international investment protection law and proposes to use similar mechanisms to analyze the WTO law to design more optimal contracts.

I. Introduction

Measures taken by states, be it in normal times or in times of crises, are often restricted by international law. As Argentina has learned after its 2001/2002 economic crisis which has been compared to the Great Depression in the United States in the 1930s,¹ that measures taken, *inter alia*, under emergency law, can lead to state responsibility under international law vis-à-vis foreign investors. The current financial crisis has shown that such financial and economic crises are not confined to developing countries alone.² Whether the various bail-out measures taken in 2008 by several OECD countries are in conformity with international law, especially international investment law and its national treatment requirement, is still an open question. Buying toxic assets from a national bank, e.g., but not from foreign banks operating in that country could violate the non-discrimination principle. Furthermore, regulation on public policy grounds by

* Max-Schmidheiny Tenure Track Professor of Law and Economics, Public Law, International and European Law at the University of St. Gallen, Switzerland, Guisanstrasse 36, CH-9010 St. Gallen, Email: anne.vanaaken@unisg.ch. I would like to thank Rekha Oleschak and Stefan Voigt for helpful comments.

¹ Liberty's Great Advance, *The Economist* (A Survey of Capitalism and Democracy), 28 June 2003, at 4, 6.

² Alan Greenspan, We will never have a perfect model of risk, Comment, *Financial Times*, 16 March 2008.

developed and developing states has been subject to the scrutiny of international investment tribunals ever more in the last ten years.

As with every legal system, international investment protection law faces a trade-off: on the one hand, its legal norms are meant to create legal security and stability, on the other hand, the laws relating international investment protection try to accommodate unforeseen and special circumstances in individual cases as a requirement of justice. But how strict or flexible is investment law as part of international economic law, e.g. in comparison with world trade law as codified in the WTO Agreement and its Annexes?³ What kind of balance between legal security and flexibility is found in the treaty texts and in the jurisprudence of investment tribunals?

In order to analyze these questions, this contribution draws on economic contract theory, asking whether investment law accommodates insights from optimal contracting. Bilateral Investment Treaties (BITs) or International Investment Agreements (IIAs⁴) may be interpreted as mechanisms to overcome commitment problems between investor and host state in order to generate mutual benefits. Thereby, a state promises not to infringe on the property rights of foreign direct investors so as to attract more investment that should ultimately foster development. Here, states trade credibility for sovereignty, as international investment law not only restricts regulatory conduct of states to an unusual extent, but also subjects it to control through compulsory international adjudication mechanisms. A well-known problem in contract theory is that of dealing with uncertainty.⁵ Parties cannot easily design contracts that maximize jointly beneficial investments and at the same time respond appropriately to changing conditions *ex post*. Changing conditions are a prevalent characteristic in investment law since most foreign investments are made with a long-term perspective in mind. Contract theory finds that too strict

³ Marrakesh Agreement establishing the World Trade Organization, done at Marrakesh, 15 April 1994, entry into force 1 January 1995, 1867 U.N.T.S. 154. The WTO Agreements contain several flexibility mechanisms, e.g. in the General Agreement on Tariffs and Trade (GATT) Art. XII (Restrictions to Safeguard the Balance of Payments), Art. XVIII (infant industry protection and balance of payments crises), Art. XIX (Emergency Actions on Imports of Particular Products, also known as the “safeguards clause”), Art. XX (General Exceptions), Art. XXI (Security Exceptions), and Art. XXVIII (Modification of Schedules, also known as tariff renegotiation). See for a detailed analysis: Simon Schropp, *Trade Policy Flexibility and Enforcement in the WTO. A Law and Economics Analysis* (Cambridge: Cambridge University Press, 2009) forthcoming.

⁴ The term ‘International Investment Arrangements’ (IIAs) includes both Preferential Trade and Investment Agreements (PTIA) that include investment protection and BITs, see UNCTAD, ‘Intellectual Property Provisions in International Investment Arrangements’, <www.unctad.org/sections/dite_pccb/docs/webiteiia20071_en.pdf> (visited 12 July 2008), at 2.

⁵ See for a thorough treatment of uncertainty in international relations, especially concerning the capacity of states to implement international treaties in internal policies, George W. Downs and David M. Rocke, *Optimal Imperfection? Domestic Uncertainty and Institutions in International Relations* (Princeton: Princeton University Press, 1995) and for uncertainty in contracts as applied to PIL, see Robert E. Scott and Paul B. Stephan, *The Limits of Leviathan. Contract Theory and the Enforcement of International Law* (New York: Cambridge University Press, 2006).

and inflexible contracts may impair the joint surplus of the contracting parties. Thus, a trade-off arises between *ex ante* strong commitment devices on the one hand and flexibility *ex post* in order to uphold the efficiency of the contract on the other hand. Generally speaking, states will participate in the system only if the expected costs of constraining (regulatory) sovereignty through BITs and state contracts does not exceed the expected (net) benefits; in contract theory terms: the participation constraint of states must be met. States can and already do react to this trade-off in various ways if they think that the pendulum has swung too far. It is hypothesized that having too strict commitments without allowing for adequate flexibility may lead to reactions by states which may endanger the system as a whole and thereby lead to the ultimately undesired result of less protection for foreign direct investment (FDI) in the long run.

This paper is organized as follows: first, a short overview on the functioning of international investment law is provided. The second part will sketch the economic logic of BITs, drawing on economic contract theory. The third part applies this theory to investment law, distinguishing between explicit and interpretational flexibility devices in investment law. Here, comparisons will also be made with the law of the World Trade Organization (WTO). The potential reaction possibilities of states with examples of reactions already occurring are analyzed in the fourth part. The last section concludes.

II. International Investment Law – An Overview

Whereas international trade in goods and services is mainly governed by the WTO Agreement and its Annexes, there is no international legal equivalent for the governance of international investment, which constitutes a major part of the international capital flow.⁶ Several attempts to draft an international agreement on investment have failed: most recently, the Draft Multilateral Agreement on Investment, negotiated under the auspices of the OECD, failed spectacularly in 1998⁷ and also the attempt to negotiate that topic under WTO auspices has stalled for the time being, when the so called “Singapore issue” of investment was taken from the negotiating agenda

⁶ In 2007, total FDI inflows reached a record of \$1.833 trillion USD thereby outpacing the increase in trade, UNCTAD, *World Investment Report 2008* (Geneva/New York: UNCTAD, 2008), at 3.

⁷ In 1995, OECD Ministers launched negotiations on a multilateral agreement on investment (MAI) with high standards of liberalization and investment protection, with effective dispute settlement procedures, and open to non-OECD Members. Negotiations were discontinued in April 1998 and will not be resumed. For the negotiating history and reasons for failure, see Rainer Geiger, 'Towards a Multilateral Agreement on Investment', 31 *Cornell International Law Journal* 467 (1998). For the text of the draft see <http://www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf> (visited 13 November 2008).

of the Doha Development Round in the summer of 2004.⁸ Thus, there are no encompassing multilateral legal rules concerning foreign direct investment. Nevertheless, the legal protection of foreign property has a long history⁹ and there exist norms of Customary International Law (CIL) protecting foreigners, including investors; these include the so called “Minimum Standard of Treatment”¹⁰ and compensation requirements for expropriations.¹¹ But this protection is - *nomen est omen* - minimal and does not live up to the modern-day requirements of protection as interference with property rights is much more refined nowadays: most contentious issues are not those connected with outright expropriation but rather with regulatory expropriation or unfair treatment and disputes over contractual rights elevated to international law claims.

Since the conclusion of the first modern BIT between Germany and Pakistan in 1959, foreign investment is governed ever-more by BITs as well as by bilateral or regional Free Trade Agreements (FTAs) which include chapters on investment protection, such as the North American Free Trade Agreement (NAFTA).¹² IIAs usually tend to have quite similar substantive provisions;¹³ however, the wording sometimes differs in detail.

⁸ Ministers from WTO member-countries decided at the 1996 Singapore Ministerial Conference, Singapore Ministerial Declaration, WT/MIN(96)/DEC, Adopted on 13 December 1996, to set up new working groups: on trade and investment, on competition policy, on transparency in government procurement as well as trade facilitation. The carefully-negotiated mandate was for negotiations to start after the 2003 Cancún Ministerial Conference, “on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations”. There was no consensus, and the members agreed on 1 August 2004 to drop the issues (except trade facilitation) from the Doha agenda.

⁹ For an overview see Andreas F. Lowenfeld, *International Economic Law* (Oxford: Oxford University Press, 2002), at 391-414.

¹⁰ For a discussion of the customary international law character of protective norms in BITs, see Bernard Kishoiyian, 'The Utility of Bilateral Investment Treaties in the Formulation of Customary International Law', 14 *Northwestern Journal of International Law and Business* 327 (1994) and Abdullah Al Faruque, 'Creating Customary International Law through Bilateral Investment Treaties: A Critical Appraisal', 44 *Indian Journal of International Law* 292 (2004), arguing against the formation of CIL through BITs, as well as Matthew C. Porterfield, 'An International Common Law of Investors Rights?' 27 *University of Pennsylvania Journal of International Economic Law* 79 (2006), arguing against the acceptance of even the Minimum Standard of Treatment as a CIL norm due to its vagueness. Arguing for the formation of CIL through BITs is Steffen Hindelang, 'Bilateral Investment Treaties, Custom and a Healthy Investment Climate - The Question of Whether BITs Influence Customary International Law Revisited', 5 *Journal of World Investment and Trade* 789 (2004); Stephan Schwebel, 'The Influence of Bilateral Investment Treaties on Customary International Law', 98 *Proceedings of the American Society of International Law* 27 (2004).

¹¹ The so called „Hull-rule“ which called for prompt, adequate and effective compensation in case of expropriation. This rule lost its customary law character in the seventies due to several UN General Assembly Resolutions in the 1960s and 70s; e.g. Art. 2 of Charter of Economic Rights and Duties of States, GA Res. 3281 (XXIX), 29 GAOR, Supp. (No. 31), 50, UN Doc. A/9631 (1974), 14 I.L.M. 251 (1975). Nevertheless, this kind of compensation requirement is now to be found in the BITs. See for details and an economic explanation for the at the first sight paradoxical behavior of developing countries, Andrew T. Guzman, 'Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties', 38 *Virginia Journal of International Law* 639 (1998).

¹² North American Free Trade Agreement, done at Ottawa; Mexico, D.F.; Washington, D.C., 17 December 1992, entry into force 1 January 1994, 32 I.L.M 289 (1993), Chapter 11. UNCTAD, above n 6, at 16, states that 12 IIAs were concluded in 2007, bringing the total of such agreements to 254. Most of the agreements concluded in 2007 are,

IAs generally include the definition of the scope of application, i.e., a definition of what constitutes an investment and of who counts as a foreign investor for the admissibility of a claim.¹⁴ The definition of investment tends to be asset-based and thus very broad and so is also the definition of “investor”. Determination of nationality, one of the main bedrocks of any BIT, of natural persons is usually uncontested, yet determining the nationality of a juridical person could turn out to be more difficult, as it can be defined by the place of incorporation, by seat or by control of the owners. IAs vary in their definitions and may use those requirements cumulatively. Rights of minority investors are usually included in the protection of the BITs, independent of the rights of the company itself, which may be incorporated in the host state.¹⁵

Further, IAs contain general standards of treatment. They provide protection against direct and indirect (also “creeping”, “tantamount to”) expropriation,¹⁶ the latter giving rise to numerous debates on the fine line between legitimate regulatory non-compensable measures of the host state and compensable regulatory expropriations.¹⁷ They also require fair and equitable treatment of the investor,¹⁸ provide for national treatment and often contain a most favored nation

in their investment chapters, comparable to BITs, including with regard to dispute settlement. See generally UNCTAD, 'Investment Provisions in Economic Integration Agreements', (Geneva/New York: UNCTAD, 2006).

¹³ See for an overview on BITs, see Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (Dordrecht: Martinus Nijhoff, 1995); Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford: Oxford University Press, 2008).

¹⁴ See David A.R. Williams QC, 'Jurisdiction and Admissibility', in Peter Muchlinski/Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law* (Oxford: Oxford University Press, 2008), 868-931, at 870-906.

¹⁵ This is by now established case-law, see e.g. *GAMI Investments, Inc. v. Mexico*, NAFTA by UNCITRAL Rules, Final Award (15 November 2004), at paras. 26-42, where the investor had 14.18 % of the total shares as well as *CMS Gas Transmission Company v. Republic of Argentina*, (ICSID Case No. ARB/01/8), Decision on Jurisdiction (17 July 2003), para. 51 ff. See for an overview Stanimir A. Alexandrov, 'The “Baby Boom” of Treaty-Based Arbitrations and the Jurisdiction of ICSID Tribunals: Shareholders as “Investors” and Jurisdiction Ratione Temporis', 4 *The Law and Practice of International Courts and Tribunals* 19 (2005).

¹⁶ Instead of many, see August Reinisch, 'Expropriation', in Peter Muchlinski/Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law*, (Oxford: Oxford University Press, 2008), 407-58.

¹⁷ Rudolf Dolzer, 'Indirect Expropriations: New Developments?' 11 *New York University Environmental Law Journal* 64 (2002); OECD, "'Indirect Expropriation" and the "Right to Regulate" in International Investment Law', Working Papers in International Investment Number 2004/4 (2004); Andrew Paul Newcombe, 'The Boundaries of Regulatory Expropriation in International Law', 20 *ICSID Review-Foreign Investment Law Journal* 1 (2005); Simon Baughen, 'Expropriation and Environmental Regulation: The Lessons of Nafta Chapter Eleven', 18 *Journal of Environmental Law* 207 (2006); Ursula Kriebaum, 'Regulatory Taking: Balancing the Interests of the Investor and the State', 8 *Journal of World Investment and Trade* 717 (2007).

¹⁸ Instead of many, see Stephen Vasciannie, 'The Fair and Equitable Treatment Standard in International Investment Law and Practice', 70 *The British Yearbook of International Law* 99 (2000); Rudolf Dolzer, 'Fair and Equitable Treatment: A Key Standard in Investment Treaties', 39 *International Lawyer* 87 (2005); Christoph Schreuer, 'Fair and Equitable Treatment in Arbitral Practice', 6 *Journal of World Investment and Trade* 357 (2005); Stephan Schill, 'Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law', 3 *Transnational Dispute Management*, online journal (2006); see Dolzer and Schreuer, above n 13, at 119-149.

clause (MFN)¹⁹ as a multilateralization device whose application is sometimes extended to procedural²⁰ and even jurisdictional matters.²¹ They also might contain a so-called “umbrella clause”, which is a general promise to honor the obligations a state has entered into with the foreign investor, usually some contractual agreements, such as licenses or concession agreements. Such clauses may elevate contractual claims to international law claims and are therefore quite contested.²²

Last, but not least, almost all treaties provide for international dispute settlement whereby states waive their immunity from suit. The establishment of a private course of action with the possibility of obtaining damages for an international wrong transforms the context of international economic law by changing the incentive structure of the actors involved. The system is unique for public international law (PIL) in that it gives investors *ius standi* to take disputes to international tribunals directly, mostly without exhaustion of local remedies. This provision thus gives international investment law immense force as private (juridical) persons are much more likely to take up their own cases than relying on governments to grant them diplomatic protection as used to be the case. The principal forum chosen for investment arbitration is the International Centre for Settlement of Investment Disputes (ICSID),²³ but arbitration also takes place under

¹⁹ See Rudolf Dolzera and Terry Myers, 'After Tecmed. Most-Favored-Nation Clauses in Investment Protection Agreements', 19 ICSID Review 49 (2004); Dolzer and Schreuer, above n 13, at 256; Okezie Chukwumerije, 'Interpreting Most-Favoured-Nation Clauses in Investment Treaty Arbitrations', 8 Journal of World Investment and Trade 597 (2007) at 643.

²⁰ Jürgen Kurtz, 'The MFN Standard and Foreign Investment - An Uneasy Fit?', 5 Journal of World Investment and Trade 861 (2004); Jürgen Kurtz, 'The Delicate Extension of MFN Treatment to Foreign Investors: Maffezini v. Kingdom of Spain', in Todd Weiler (ed), *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (London: Cameron May, 2005), 523-56; Scott Vesel, 'Clearing a Path Through a Tangled Jurisprudence: Most-Favored-Nation Clauses and Dispute Settlement Provisions in Bilateral Investment Treaties', 23 Yale Journal of International Law 125 (2007), Dana H. Freyer and David Herlihy, 'Most-Favored-Nation Treatment and Dispute Settlement in Investment Arbitration: Just How “Favored” is “Most-Favored”?' 20 ICSID Review Foreign Investment Law Journal 58 (2005); Yannick Radi, 'The Application of the Most-Favoured-Nation Clause to the Dispute Settlement Provisions of Bilateral Investment Treaties: Domesticating the “Trojan Horse”', 18 European Journal of International Law 757 (2007); Emmanuel Gaillard, 'Establishing Jurisdiction Through a Most-Favored-Nation Clause', 233 New York Law Journal online journal (2005).

²¹ *RosInvestCo UK Ltd v. Russian Federation* (SCC Case No V079/2005) Jurisdiction Award, signed October 2007. See for a discussion of the latest developments in the MFN clause in procedural and jurisdictional issues, Anne van Aaken, 'The Most Favored Nation Clause in Investment Arbitration: Is it taking an Unfavorable Development?' (Paper presented at the Investment Committee of the International Law Association, Rio de Janeiro, August 2008, on file with the author).

²² Instead of many, see Thomas Wälde, 'The "Umbrella" Clause in Investment Arbitration: A Comment on Original Intentions and Recent Cases', 6 Journal of World Investment and Trade 183 (2005); Bjorn Kunoy, 'Singing in the Rain: Developments in the Interpretation of Umbrella Clauses', 7 Journal of World Investment and Trade 275 (2006); Dolzer and Schreuer, above n 13, at 153-162.

²³ Convention on the Settlement of Investment Disputes between States and the Nationals of Other States (ICSID Convention), done at Washington D.C., 18 March 1965, entry into force 14 October 1966, 575 U.N.T.S. 159. For an

other rules such as the United Nations Commission on International Trade Law (UNCITRAL) or International Chamber of Commerce (ICC) rules.²⁴ The ICSID Convention was created in 1965 under World Bank auspices with the goal of fostering private capital flow to developing countries. Whereas there is no uniform text of international investment protection and no sitting judicial body, like the Appellate Body in WTO, there exists nevertheless a corpus of fairly similar substantive provisions. Since the composition of the tribunals varies from case to case, so may their interpretations. Although some of the variations may be attributed to a difference in the wording of the treaty text, sometimes tribunals also interpreted identical wording in different ways, leading to inconsistent interpretation.²⁵ Many of the interpretations of the vague terms to be found in the BITs are thus highly disputed, thereby creating legal insecurity for investors and states.²⁶ Nevertheless, the set-up of this enforcement system makes investment law very effective, since claims face no hurdle of either diplomatic protection or local remedies requirements. Direct sanctions consist of damages to be paid which may be quite high for developing countries.²⁷ Quite as forceful are the indirect sanctions of reputational effects of being an unreliable host state,²⁸ at least in some instances.²⁹ A bad (or good) reputation may be

overview on ICSID arbitration including its advantages and disadvantages, see Lucy Reed/Jan Paulsson and Nigel Blackaby, *Guide to ICSID Arbitration* (The Hague: Kluwer Law International, 2004); Christoph Schreuer, *The ICSID Convention. A Commentary on the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States* (Cambridge: Cambridge University Press, 2001).

²⁴ UNCTAD, above n 6, figure I.14.

²⁵ Christoph Schreuer and Matthew Weiniger, 'A Doctrine of Precedent?' in Peter Muchlinski/Federico Ortino and Christoph Schreuer (eds), *The Oxford Handbook of International Investment Law*, (Oxford: Oxford University Press, 2008), 1188-206.

²⁶ This has given rise to various proposals on the procedure, the most prominent one for an appellate mechanism, see e.g. Susan D. Franck, 'The Legitimacy Crisis in Investment Arbitration: Privatizing Public International Law Through Inconsistent Decisions', 73 *Fordham Law Review* 1521, 1617–1625 (2005) and Gus van Harten, *Investment Treaty Arbitration and Public Law* (Oxford: Oxford University Press, 2007) (arguing for independent investment courts).

²⁷ Even though Argentina is an extreme case due to the emergency measures it has taken in its economic crisis 2000/2001, some estimations are around 80 billion USD in damages claimed in around 44 originally pending cases in connection with the crisis, see William W. Burke-White and Andreas von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties', 48 *Virginia Journal of International Law* 307 (2008), at 311. This would amount to almost double the amount of the annual state revenue around 50 billion USD in 2007, see CIA World Factbook, <https://www.cia.gov/library/publications/the-world-factbook/geos/ar.html#Econ> (visited 13 November 2008). In those cases which have been decided, the tribunals have awarded on average approximately 33% of the damages claimed by the investors, see UNCTAD, Latest Developments in Investor-State Dispute Settlement, UNCTAD, Doc. UNCTAD/WEB/ITE/IIA/2008/3 IIA MONITOR NO. 1 1-2 (2008), at 11 http://www.unctad.org/en/docs/iteiia20083_en.pdf (visited 13 January 2009).

²⁸ See for an economic theory of compliance also based on reputational effects, Andrew Guzman, *How International Law Works: A Rational Choice Theory* (New York: Oxford University Press, 2008). See also Scott and Stephan, above n 5, at 68.

²⁹ This did not hold true after the Argentinian or Russian default: investors went back quite quickly.

reversed by a new, investment-friendly government which may take measures in order to appear more credible and in order to attract investment (or reverse a favorable investment policy).

III. The Contract Theory Approach

In order to understand the underlying logic of BITs, this article draws on economic contract theory,³⁰ assuming that states (as well as enterprises) act rationally when concluding treaties or contracts. Traditionally, the *legal* analysis of contracts takes an *ex post* perspective, that is, it focuses on rights and obligations after there has been an alleged breach as well as the recovery of losses for the injured party. Contract theory shifts the focus to the *ex ante* decision to why and under what circumstances parties enter into a contract in the first place, thus acknowledging the consensual approach as well as the participation constraint of parties.³¹ Enforceable contracts are a mechanism for achieving compliance with cooperative goals that are supposed to benefit the collective interest (or joint surplus) of parties whose particular interest may diverge at a given time. Contract theory is primarily an analytical approach for explaining why parties enter into contracts in the first place and why they write the contracts they do, in light of what courts do. It also helps to answer questions of optimal contracting. It is based on information economics and the distribution of risks in a contract.

The best starting point for analysis is the contract which yields optimal outcomes, that is, the first-best contract which can be used as a bench-mark. This “Pareto-efficient complete contingent contract”³² is the one parties would write if there were no contracting imperfections, such as bounded rationality and unforeseeability, no transaction costs and no enforcement costs. Such contracts would assign risks, rights and responsibilities to every possible state of the world. The context of the contract would be free of market imperfections, unforeseen developments and opportunistic behavior. In such a contrafactual situation, parties would maximize their *ex ante* commitment as there are no assurance problems. Unfortunately, we do not live in this Panglossian world. Complete contracts which foresee every contingency are impossible to draft

³⁰ For a short overview of incomplete contracting in a commercial law setting, see Robert E. Scott, 'The Law and Economics of Incomplete Contracts', 2 Annual Review of Law and Social Science 279 (2006).

³¹ This constraint is a notion of game theory, more specifically mechanism design: it is satisfied if a mechanism leaves all participants at least as well off as they would have been had they not participated in contracting.

³² Steven Shavell, 'Damage Measures for Breach of Contract', 11 Bell Journal of Economics 466, (1980) at 467.

and even trying to come close creates high negotiating costs. This, in turn, gives rise to the impossibility to foresee and describe appropriately the contractual outcome for all states of the future world: “Contracts will be incomplete in the sense that they will fail to discriminate between states of the world that optimally call for different obligations.”³³ Contract theory distinguishes between uncertainty over the future (unforeseeability), uncertainty over the actions of the others players (asymmetrical information), uncertainty over the meaning and scope of the contractual provisions (i.e. textual ambiguity and legal indeterminateness). Information asymmetries between the parties pose the biggest problem: each party has information about itself (private information) which the other has not, giving rise to potential opportunism. Thus, contract theory analyzes problems of adverse selection, moral hazard and verification.³⁴

Parties entering into contracts usually face a problem: the contract should be optimal from an *ex ante* perspective, that is, it should encourage the parties at the time of the conclusion of the contract to invest in the contractual relationship so as to maximize the anticipated joint benefits. However, at the same time, parties want to write a contract that is 'optimal *ex post*, that is, a contract that is still value maximizing after all future uncertainties have been resolved as of the time of performance.³⁵ These two partially conflicting goals create an inherent tension as *ex ante* each party would like to ensure the commitment of the other but subsequent events may render inflexible commitments inconsistent with the contractual objective of maximizing the joint surplus. This problem becomes acute in long term contracts such as BITs but also in state contracts, e.g. in natural resource or public utility concessions which often have durations of more than 25 years.³⁶ Unforeseen circumstances may cause the cost to one of the parties to complete a

³³ Scott and Stephan, above n 5, at 76. Jean Tirole, 'Incomplete Contracts: Where do We Stand?', 67 *Econometrica* 741 (1994) at 743, defines an incomplete contract as one that “does not exhaust the contracting possibilities envisioned in the complete contract”.

³⁴ Contract theorists distinguish between observable and verifiable information. The former can be observed by the two parties but it may still be that the information is not verifiable in the sense that the observing party is unable to establish the fact sufficiently to convince a neutral third party at reasonable cost, e.g. the investment tribunal. See for details Scott and Stephan, above note 5, at 71-72.

³⁵ *Ibid*, at 61.

³⁶ Therefore, in *The Government of the State of Kuwait v. The American Independent Oil Company (AMINOIL)*, I.L.M. 1982, 976, 1023, at para. 95, the tribunal stated that sovereignty rights may not be waived for such a long time (60 years). It held that “,(W)ith reference to every long-term contract, especially such as involve an important investment, there must necessarily be economic calculations, and the weighing up of rights and obligations, of chances and risks, constituting the contractual equilibrium... It is in this fundamental equilibrium that the very essence of the contract consists.” (at para. 148). The Iran-US Claims Tribunal, *Amoco International Finance Corporation and Government of the Islamic Republic of Iran*, Partial Award No. 310-56-3 of 14. July 1987, 83 ILR 501, reprinted in 27 I.L.M. 1314, at para. 179 held: “In the present case, the Khemco Agreement was concluded for a shorter period (35 years) than the concession in the AMINOIL case (60 years), but in economic and legal terms 35 years cannot be considered a "relatively limited period.”

promised investment to exceed the value that the counterparty expected to generate from the contract.³⁷ For host states' governments, these costs may not only be economic but also political, since the "non-regulation of prices" or the privatization of public services may be met with unrest.³⁸

It is well acknowledged in contract theory that the advantage of writing a contract with "hard" and precise terms is to ensure credible commitments, as "hard" terms are less open to interpretation and the uncertainty of risk-shifting to the injured party which comes with it. But unless the parties can 'fully and accurately anticipate the conditions that exist at the time of performance, a contract containing only "hard" terms will always turn out to be suboptimal once the future arrives. [...] In short: once conditions change, a contract with hard terms will lead to outcomes that are less desirable than those the parties would have agreed to had they known the uncertainties in advance.'³⁹ Anticipating this, the parties would then want flexibility to adjust the investment whenever future circumstances make the investment no longer profitable (for either side). More flexibility in turn leads to a weakening of the credibility of the parties *ex ante*. In contracting, there is, thus, a trade-off between the credibility of a commitment on the one hand and the desired *ex post* flexibility on the other.

A balance needs to be found between commitment and flexibility with the following goals of the contract in mind: securing a high level of cooperation *ex ante*, distinction between (desired) flexibility to new circumstances on the one hand and cases of purely opportunistic breach of the contract *ex post* on the other as well as adequate compensation for the victim. Specifically if parties have contracted under a veil of ignorance, that is, they do not know whether they will be victim or injurer,⁴⁰ one would expect the following kind of drafting: An optimal contract would be able to specify the flexibility needed. It would distinguish between intra-contractual, that is contractually permissive behavior provoked by an outside shock (unanticipated contingency) and proportionate measures based on legitimate regulatory goals and extra-contractual, that is, impermissible behavior attributable to opportunistic behavior. An optimal contract would mandate flexibility in the first case and rigidity in the second. Whereas rigidity harms the injurer,

³⁷ Scott and Stephan, above n 5.

³⁸ As e.g. in Argentina's economic and political crisis of 2000/2001 which gave rise to 44 disputes or the public unrest in the case *Aguas del Tunari v. Bolivia*, (ICSID Case No. Arb/02/3), Decision on Jurisdiction (21 October 2005).

³⁹ Scott and Stephan, above n 5 at 77.

⁴⁰ See similarly Alan O'Neil Sykes, 'Protectionism as a "Safeguard": A Positive Analysis of the GATT 'Escape Clause' With Normative Speculations', 58 *University of Chicago Law Review* 255 (1991) for WTO law.

flexibility harms the victim but both errors are likely to reduce the *ex ante* cooperation of the parties. In case of investment law, there is no uncertainty as to which party is the victim or the injurer. *De lege lata*, always the state, not the investor is the injurer, since the state is not protected under the BITs (it may only invoke non-compliance of the investor with, e.g., a concession contract as a defense). What is in principle uncertain is which of the two contracting states will be the injurer. Until more recently it was mostly the capital importing, developing states. This has changed, first under NAFTA and now more generally since capital flows are not unidirectional anymore.⁴¹ Well developed states are sued under the BITs.⁴² Thus, rigidity always hurts states since certain risks are shifted to them whereas flexibility usually hurts the investor since the risk allocation is on his side. The rigidity of a BIT or a contract (in the interplay with the BIT through umbrella clauses) influences the propensity to invest by the investor positively but the participation constraint of states has to be taken into account.

Unanticipated contingencies, would they have been known *ex ante*, would have changed the initial content of the contract. If the unforeseen circumstances (contingency) are not provided for in the contract, regret occurs if the “complete contingent contract” would have excused performance but the real contract erroneously mandates performance.⁴³ The regret is thus a function of “the magnitude of the unexpected contingency, or shock (the “regret contingency”) and the level of *ex ante* commitments.”⁴⁴ Contracts usually do try to distinguish between opportunistic behavior (bad faith) and unforeseen contingencies (good faith) and mandate different legal consequences (damages) for both.⁴⁵ Regret contingency is different from

⁴¹ In investment law, capital flows have until recently been largely unidirectional from developed to developing countries, that is, in reality states knew who will be the injurer (the host state) and who the victim (the investor from the developed country). This is changing, see UNCTAD, *World Investment Report 2006* (Geneva/New York: UNCTAD, 2006). Furthermore, an increasing number of BITs and FTAs are now concluded between developing countries.

⁴² At least 73 governments – 45 of them in the developing world, 16 in developed countries and 12 in Southeast Europe and the Commonwealth of Independent States – have faced investment treaty arbitration. Argentina (46 cases), Mexico (18 cases), the Czech Republic (14 cases) and the US (12 cases) as well as Canada (12 cases) have found themselves mostly in the role as a defendant. See *ibid.*, at 16.

⁴³ Example taken from Schropp, above n 3, fn. 4: „To grasp the concept of ex post regret, consider the simple example of a fixed-price (non-contingent) contract that obliges one party to produce and the other party to buy a product. An earthquake destroys the production facilities and makes delivery as prescribed extremely costly: The producer will prefer not to perform; by means of a side payment to the buyer (exceeding the latter’s personal value of the good) both parties can be made better off by not conducting the transaction.“

⁴⁴ Schropp, above n 3, at 83 (footnote 147) and for a numerical example Shavell, above n 32, footnote 4.

⁴⁵ Matching the damages with the cause of breach in investment law would exceed the scope of this article and must be left to future research. Economic theory on efficient breach recommends expectation damages for inducing performance when it is efficient, and breach when it is not, since expectation damages place the promisee in as good as a position as it would have been in, if the promisor had performed. See Robert Cooter and Thomas Ulen, *Law and Economics*, 4th ed. (Boston et al.: Pearson/Addison Wesley, 2004), at 201-205. On the question of damages in

opportunism in that the former is welfare enhancing (*ex post*) for both parties whereas opportunism is welfare decreasing for the victim. It follows that the former should be permitted in the contract whereas the latter should not. Parties anticipating unaccounted regret contingencies may, in games with repeated interaction, such as investment law, react, due to learning effects for the future. Parties might thus either choose to express their obligations in more general terms and delegate the interpretation to third parties in order to account for the necessary *ex post* flexibility or to have explicit flexibility mechanisms in the contract. The crucial criteria in contract theory is whether appropriate proxies for the contested circumstances can be specified *ex ante* or whether a disinterested third party can be trusted to make such a selection *ex post* with the benefit of hindsight. Contract theory therefore distinguishes between precise and vague terms (or rules v. standards or hard v. soft norms), with standards delegating more discretion to courts and tribunals than rules. Usually a combination of both is found.

IV. A Contract Theory Approach to Investment Law

Although contract theory was developed mainly for individuals contracting (and not for collectivities such as states), it has recently also been applied to international relations.⁴⁶ If it is used in international relations, usually state-to-state contracting is analyzed, as in a classical Westphalian system. Investment law differs in that there are more actors involved. IIAs establish rights for third parties. Thus, the actors concluding the investment treaty (states) are partially different from those acting under the treaty (the host state and the investor). Legally speaking, BITs are contracts in favor of third parties.⁴⁷ This implies that reciprocity in the strict sense as used in contract theory⁴⁸ but also in international law is not applicable, also not for questions of

investment law, see Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law* (London: British Institute of International and Comparative Law, 2008). If damages awarded are higher than expectation damages, "efficient breach" is discouraged, maybe leading to inefficient behavior of the host state. See for a discussion of contracts covered by BITs, see Fabrizio Marrella and Irmgard Marboe, "Efficient Breach" and Economic Analysis of International Investment Law', 4 Transnational Dispute Settlement; Online Journal 6, (2007).

⁴⁶ For the WTO, see Schropp, above n 3, more generally see Jeffrey L. Dunoff and Joel P. Trachtman, 'Economic Analysis of International Law', 24 Yale Journal of International Law 1 (1999) as well as Scott and Stephan, above n 5.

⁴⁷ See German Constitutional Court Decision BVerfG, 2 BvM 1/03 of 8 May 2007, at para. 51. Available at: http://www.bverfg.de/entscheidungen/ms20070508_2bvm000103.html (visited 10 January 2009).

⁴⁸ For reciprocity as an informal enforcement mechanism in contract theory, see e.g. Scott, above n 30, at 295 and for reciprocity in international law, see Beth V. Yarbrough and Robert M. Yarbrough, 'Reciprocity, Bilateralism, and Economic 'Hostages': Self-Enforcing Agreements in International Trade', 30 International Studies Quarterly 7 (1986); Francesco Parisi and Nita Ghei, 'The Role of Reciprocity in International Law', 36 Cornell International Law Journal 93 (2003).

self-enforcing mechanisms of compliance. Nevertheless, contract theory promises some insights also on optimal contracting in investment law.

A. Applying Contract Theory to Investment Law

Undisputedly, countries, especially developing ones, have a strong incentive to attract FDI and compete for it.⁴⁹ The fundamental problem for countries is to make protection of FDI more credible.⁵⁰ The potential host state can promise to honor the property rights of the investor *ex ante*, but may renege opportunistically on its promises *ex post* if there are no sanctions. Firms usually cannot disinvest in full once they have placed a fix investment as those investments are usually relation-specific;⁵¹ there is thus a hold-up problem.⁵² States can take advantage of this in several ways, e.g. by denying due process in administrative proceedings, by changing the royalty division in case of natural resources extraction, or simple expropriation. Economic theory predicts that the host state will do so if the net benefit of renegeing on its promise is greater than the net benefit of complying with its promise.⁵³ As firms anticipate the possibility, at some point, of expropriation or unfair treatment, they may refrain from investment - and the result would be a socially undesirable investment level. Of course, not all regulatory measures of states which affect investors negatively are the result of opportunistic behavior. Rather, some cases deal with

⁴⁹ See Beth Simmons/Elkins Zachary and Andrew Guzman, 'Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000', 2008 Illinois Law Review 265 (2008); Guzman, above n 11.

⁵⁰ This applies certainly to states which do not have a strong property rights protection in national law which in turn leads to the problem that they may not have the capability to be able to live up to the "one size fits all" provisions of BITs. Furthermore, also "rule of law" states as the United States have been a defendant in many cases.

⁵¹ Relation specificity or asset specificity is usually defined as the extent to which the investments made to support a particular transaction have a higher value to that transaction than they would have if they were redeployed for any other purposes. See seminal Oliver. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975) as well as Scott, above n 30, at 283 ff. If the contract is not performed, the costs of the investment are sunk.

⁵² Hold-up problems occur when two parties may be able to cooperate most efficiently but refrain from doing so due to concerns that they may give the other party increased bargaining power, and thereby reduce their own profits. See Oliver E. Williamson, 'Transactions-Cost Economics: The Governance of Contractual Relations' 22 *Journal of Law and Economics* 233 (1979).

⁵³ Here, some issues may be contested. The first problem is the definition of the preference functions of states or, to be more precise, of the government in power at a certain time. Furthermore, the question costs included in the calculus are of importance: are only direct sanctions via a damage claim to be calculated or also indirect sanctions, like reputational costs? The ongoing discussion in international law and international relation literature can not be surveyed here, for two rational choice approaches mirroring the different approaches, see Guzman, above n 28 on the one hand and Jack L. Goldsmith and Eric A. Posner, *The Limits of International Law* (Oxford: Oxford University Press, 2005) on the other hand.

measures taken in good faith in order to deal with unforeseen contingencies.⁵⁴ Nevertheless, also non-discriminatory good faith measures have been found to be a breach of the BITs.⁵⁵

The solution to this problem is to make the commitments of the host state credible – and IIAs do exactly that. Investment protection thus becomes an instrument to attract scarce resources by reducing the risk of *ex post* opportunism of host countries.⁵⁶ BITs submit host states to a credible threat if they renege on their international law promises (that is the BIT) or on their promises in a national state contract (e.g. concession agreements) if there is an umbrella clause in the BIT. The commitment is made especially forceful and credible by international third party adjudication without the exhaustion of local remedies.

At first sight, economic logic tells us that BITs are an adequate mechanism for the commitment problem. Nevertheless, there is a downside to solving the commitment problem too successfully as we face an optimization problem. In international investment law, contractual uncertainty has many factual and legal facets: the uncertainty of opportunistic behavior by states or firms, the uncertainty of states' capacity to fulfill their international obligations through domestic regulatory policy,⁵⁷ the uncertainty of the development of world market prices for natural resources, the uncertainty of how governments react to citizens' reactions unfavorable to the investment in question, changes of government policy etc.⁵⁸ And, of course, uncertainty of how tribunals will interpret ambiguous terms in a BIT. Balancing commitment and flexibility is thus needed in the face of uncertainty. There can be two reasons for too rigid law: either the treaty is written as completely as possible with strict promises and without explicit flexibility

⁵⁴ As Ian Brownlie, *Principles of Public International Law* 6th ed. (Oxford: Oxford University Press, 2003), at 523 holds: „A government acting in good faith may enact exchange control legislation or impose trade restrictions which incidentally (and without discrimination) lead to the annulment or non-enforceability of contractual rights. It is difficult to treat such action as illegal on the international plane.”

⁵⁵ E.g. *Mondev International Ltd v. United States of America*, (ICSID Arbitration No. ARB(AF)/99/2), p.40, para. 116, (11 October 2002), www.naftaclaims.org (visited 13 January 2009).; *Tecnicas Medioambientales SA v. Mexico*, (ICSID Arbitration Nr. ARB (AF)/00/2) (29 May 2003) (Tecmed), para. 153; *CMS Gas Transmission Company v. Argentine Republic*, (ICSID Case No. Arb/01/8), (12 May 2005), para. 280 holds for the interpretation of fair and equitable treatment: “The Tribunal believes this is an objective requirement unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard.”

⁵⁶ This holds at least in theory, empirical evidence of the impact of BITs on FDI has been inconclusive. In any case BITs work only at the margin. See instead of many Eric Neumayer and Laura Spees, 'Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?', 33 *World Development* 1567 (2005).

⁵⁷ See Downs and Rocke, above n 5, at 105-107.

⁵⁸ Ibid see a clear danger of a gambling for resurrection for example in case of war. In investment law, the danger is rather that the costs felt by too strict BITs are shifted by governments to successor governments (and generations), whereas the gains are reaped rather immediately.

instruments or it is written in vague terms (and thus in principle flexible terms) and tribunals interpret the terms in a (too) strict manner. Both of these will be discussed below.

B. Explicit and Interpretational Flexibility Devices

Flexibility for contractual parties can either arise from flexibility being built in the contractual agreement, thus the measure in question is viewed to be legal. Or it can arise from “efficient breach”,⁵⁹ that is, the measure is extra-legal but the parties to the contract have higher pay-offs breaching the contract (but the injurer has to compensate the victim).⁶⁰ Assume there are two kinds of BITs: one contains flexible terms and the other does not. The same behavior of a state can thus be judged in conformity with the treaty in the second case and a breach of contract in the first. Nevertheless, even if a breach occurs, flexibility of behavioral possibilities exists as long as damages are paid, that is, states can still breach the BIT as long as they pay damages. Here, the budgetary constraint of states becomes crucial. It thus makes a huge difference of whether the behavior of a state is extra-legal (and thus to be compensated) or whether it is legal and thus no budgetary constraint arises.

1. Flexibility through Escape Clauses for Exceptional Circumstances

There are several explicit flexibility instruments at hand for IIAs. First, some BITs have an explicit escape clause for unforeseen external shocks; so-called essential security clauses or “non-precluded measures”-clauses (NPM clauses). Thus, sometimes an escape from substantive BIT obligations is possible by taking measures for e.g. the “protection of its own essential security

⁵⁹ There is extensive literature on „efficient breach“, some of it critical. In a nutshell, it means that a party to a contract should be allowed to breach the contract and pay damages if it is more economically efficient than performance. Seminal, see Charles Goetz and Robert Scott, Liquidated Damages, Penalties, and the Just Compensation Principle: A Theory of Efficient Breach, 77 Columbia Law Review 554 (1977). This theory has been much criticized. The important point is that efficiency is judged only from the standpoint of the parties to the contract, possible externalities, third party effects or consequences for the system as a whole are not included in the efficiency calculus. For efficient breach in the WTO context, see Alan O’Neil Sykes and Warren F. Schwartz, The Economic Structure of Renegotiation and Dispute Resolution in the World Trade Organization, 31 Journal of Legal Studies (Supplement), S179 (2002).

⁶⁰ This means that if expectation damages have to be paid by the injurer and the damages can be calculated correctly, the injurer is better off and the victim is compensated wholly for his loss. Liability rules with expectation damages are thus a means to foster efficient breach. See *ibid*, at S181 f. There is, of course, a dispute whether Investment Law, just a WTO law, is a “contract” which may be breached or whether there are absolute obligations of states. See for a more general discussion Joost Pauwelyn, *Optimal Protection of International Law: Navigating Between European Absolutism and American Voluntarism* (Cambridge: Cambridge University Press, 2008).

interests.”⁶¹ Those clauses can cover circumstance such as exceptional threats to internal and external security, such as economic crisis, terrorism threats, public health emergencies or natural disasters. Explicit escape clauses should give the necessary flexibility to states in case of external shocks if measures are taken in good faith. Much, though, depends on the wording of the clause as well as on the interpretation by investment tribunals. The form and structure of those clauses vary widely.⁶² They differ with respect to the permissible objectives, e.g. security, international peace and security, public order, public health or public morality.⁶³ Art. 25 of the 2007 Norwegian Model BIT⁶⁴ as well as the 2004 Canadian Model BIT, e.g., include (in wise foresight) as permissible objective the protection of state finances and the banking system allowing prudential regulation,⁶⁵ maybe as a reaction to the Argentinean financial crisis.⁶⁶ The more extensive the permissible objectives the more flexibility is granted to states – and the lower the credibility-enhancing effect of the BIT, since more risk is shifted to the investor. They also differ in their scope. Some apply to all substantive provisions of the BIT, that is, a state would be absolved from all substantive protective provisions if the requirements of the NPM clause are met, or the clause covers only some substantive provisions, such as the non-discrimination provisions,⁶⁷ that is, the clause can only be invoked against some of the substantive treaty provisions. Last, but not least, NPM clauses require some link between the measures taken by the

⁶¹ Of around 2000 BITs in force those clauses appear in about 200 of those treaties. See Burke-White and von Staden, above n 27, at 313 and at 318 f. for examples of BITs which contain NPM clauses.

The US BITs are an exception in this respect. The Model BIT of 2004 (but also earlier treaties) contains such a clause in Art. 18. Similar, Art. 24 of the Energy Charter, done at Lisbon, 17 December 1994, entry into force 16 April 1998, 33 I.L.M. (1994) 381 (although it does not apply to direct or indirect expropriation).

⁶² For an extensive analysis, see Burke-White and von Staden, above n 27.

⁶³ For examples, see *ibid.*, at 326 ff.

⁶⁴ Draft Norwegian Model BIT:

<http://www.regjeringen.no/upload/NHD/Vedlegg/hoeringer/Utkast%20til%20modellavtale2.doc> (visited 10 January 2009).

⁶⁵ Canadian 2004 Model Foreign Investment Protection and Promotion Agreement (FIPA), Art. 10 (2), <http://www.sice.oas.org/Investment/NatLeg/Can/2004-FIPA-model-en.pdf> (visited 10 January 2009): „2. Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining reasonable measures for prudential reasons, such as: (a) the protection of investors, depositors, financial market participants, policy-holders, policy-claimants, or persons to whom a fiduciary duty is owed by a financial institution; (b) the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions; and (c) ensuring the integrity and stability of a Party's financial system.“

⁶⁶ Burke-White and von Staden, above n 27, at 335, footnote 133.

⁶⁷ E.g. Agreement on the Encouragement and Reciprocal Protection of Investments, Protocol, P.R.C.–F.R.G., ¶ 4(a), Dec. 1, 2003, http://www.unctad.org/sections/dite/iiia/docs/bits/china_germany.pdf (visited 10 January 2009): „Measures that have to be taken for reasons of public security and order, public health or morality shall not be deemed "treatment less favourable" within the meaning of Article 3.“

host state and the objective. Some clauses, e.g., require that the measure must be 'necessary to' achieve the objective whereas others only require a relation between the two.⁶⁸

Furthermore and crucially, there are differences in the permissible scrutiny of tribunals. Some NPM clauses are explicitly self-judging whereas others do not contain such a restriction of third-party adjudication. In the Argentinean cases, this problem was extensively discussed. The higher the judicial scrutiny permitted by the escape clause, the lesser is the flexibility granted to the host state to take essential security measures *ex post* and the higher is the commitment level *ex ante*. In principle there are three possibilities for tribunals to scrutinize the use of the escape clause by states: escape clauses can be entirely self-judging, only subject to good faith scrutiny or under full scrutiny of the tribunal.⁶⁹ The latter approach is usually taken by investment tribunals unless the clause allows explicitly for auto-interpretation which they usually do not. Tribunals fully scrutinize even against the will of both State Parties to the relevant BIT⁷⁰ - an interpretation which needs justification why Art. 31 (3) (b) Vienna Convention on the Law of Treaties (VCLT)⁷¹ was not applied. The invocation of state necessity in the BIT and in Customary

⁶⁸ How the necessity requirement is interpreted is again another question, on which tribunals vary widely, see extensively Burke-White and von Staden, above n 27, at 342 ff. The same problem can indeed be found in WTO law, see Panagiotis A. Delimatsis, 'Determining the Necessity of Domestic Regulations in Services: The Best is Yet to Come', 19 *European Journal of International Law* 365 (2008).

⁶⁹ For a discussion of the case in the broader context of state necessity and investment protection, see Anne van Aaken, 'Zwischen Scylla und Charybdis: Völkerrechtlicher Staatsnotstand und Internationaler Investitionsschutz', 105 *Zeitschrift für vergleichende Rechtswissenschaft* 544 (2006), Jürgen Kurtz, 'Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis', Jean Monnet Working Paper 06/08, available at: www.JeanMonnetProgram.org (2008), Andrea K. Bjorklund, 'Emergency Exceptions: State of Necessity and Force Majeure', in Peter Muchlinski/Federico Ortino and Christoph Schreuer (eds), *Oxford Handbook of International Investment Law*, (Oxford: Oxford University Press, 2008), 459-523, Burke-White and von Staden, above n 27.

⁷⁰ The tribunal in *CMS Gas Transmission Company v. Argentine Republic*, (ICSID Case No. Arb/01/8) (May 12, 2005) subjected the security clause provision to full scrutiny in the first Argentine Crisis Case. Even though it confirmed the applicability in economic crisis cases, it denied the protection for Argentina with the reasoning that there was no economic emergency. It also held, in contradiction to the expert opinion of Prof. Slaughter that there are no limits to the control by the Tribunal on that clause, that is, it did not defer to the assessment of the Argentine government and only checked for obvious misuse (good faith limits), as national constitutional courts would usually do. Argentina argued in its Application for Annulment and Request for Stay of Enforcement of Arbitral Award of 8 September 2005, at para. 39 that the State Department of the United States viewed such clauses as self judging. Thus, although both states involved argued for self-judgment, the tribunal did not agree. See *Gas Transmission Company v. Argentine Republic*, (ICSID Case No. Arb/01/8), Decision of the Ad Hoc Committee on the Application for Annulment of The Argentine Republic, (25 September 2007) (paras. 122-127). A similar reasoning was applied by the tribunal in *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic*, (ICSID Case No. ARB/02/1), Decision on Liability (3 October 2006) (at para. 212) The Tribunal also supported that the escape clause was not self-judging and stated that the US at the time of concluding the Argentina BIT still supported the position that these clauses were not self-judging and changed its position only later. For an extensive discussion on the US practice, see Burke-White and von Staden, above n 27, at 376 ff.

⁷¹ Vienna Convention on the Law of Treaties, done at Vienna, 23 May 1969, in force 27 January 1980, 1155 U.N.T.S. 331; 8 I.L.M. (1969) 679.

International Law⁷² by Argentina due to its economic crisis in 2000/2001 was not accepted by the majority of the tribunals,⁷³ thereby obligating Argentina to pay compensation for the tariff freeze of public utilities and its devaluation of its currency. The costs of the obligations, interpreted as they were, may thus be quite high as a country may not have the freedom anymore to react to external or internal economic or political shocks and crises without compensating foreign investors. As mentioned above, it is unclear up to date whether cases will come up in connection with the financial crises of September 2008 in OECD states due to discriminatory measures taken in the bail-outs.

Regret contingency may occur due to *ex post* inefficient contractual interpretation. In cases where private information is very difficult to verify for third parties, i.e. investment tribunals, self-judgment (or good faith control) is appropriate, as the tribunal's ability to assess all circumstances is limited and it would need to resort to second guessing the legality of measures that clearly fall within the traditional prerogative of governments.⁷⁴

This has clearly been foreseen in the world trade law. The essential security clauses in Art. XXI GATT and Art. XIV bis (a) and (b) of the General Agreement on Trade in Services (GATS) are self-judging in that they use the wording of "it considers necessary" or "which it considers contrary to its essential security interests". Also Art. 31 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) concerning compulsory licensing together with the Doha Declaration on TRIPs⁷⁵ grants states auto-interpretation in the question on what constitutes a national emergency. Those provisions basically do not put any restraint on

⁷² As codified in Art. 25 of the International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts. For the text of the Articles see Official Records of the General Assembly, Fifty-sixth session, Supplement No. 10 (A/56/10), Ch. V.

⁷³ Up to date, only a few cases against Argentina in the connection with the financial crisis have been decided (with Argentina having to pay around 2/3 of a billion USD): The following tribunals found the security clauses not fulfilled: *CMS v. Argentine Republic*, above n 70, *Enron Corporation, Ponderosa Assets L.P. v. Argentine Republic*, (ICSID Case No. ARB/01/3) (May 22, 2007); *Sempra Energy International v. Argentine Republic*, (ICSID Case No. ARB/02/16), Award, 28 September 2007.

The tribunal in *LG&E v. Argentine Republic*, above n 70, found that during 17 months, Argentina indeed was in a state of necessity. This was followed by *Continental Casualty Company v. Argentine Republic*, (ICSID Case no. ARB/03/9) (5 September 2008). Argentina's annulment application in the CMS case was in this respect unsuccessful, see Decision of the ad hoc Committee on the Application for Annulment of the Argentine Republic above n 70, although the annulment committee found serious flaws in the reasoning of the tribunal (at paras. 123-125).

See for an excellent analysis of the (faulty) interpretation, Kurtz, above n 69.

⁷⁴ As has indeed been the case in *CMS v. Argentine Republic*, above n 70.

⁷⁵ Art. 5 (b) and (c) of the Declaration on the TRIPs Agreement and Public Health (WT/MIN(01)/DEC/2), adopted on 14 November 2001.

countries; opportunistic misuse is thus possible and can be diagnosed.⁷⁶ If the BITs may go too far in the commitment, WTO law may not secure a possible distinction between opportunistic behavior on the one hand and good faith measures to secure national security on the other.

2. Flexibility through Explicit Public Policy Exceptions

Another possible flexibility mechanism is that of having general exceptions for public policy measures for public morals, public health, the environment etc. or statements that certain public policy measures do not constitute a breach of the BIT. Those explicit public policy exceptions render the treaties more flexible and at the same time restrain the interpretational leeway of tribunals, although they still leave room for judicial scrutiny, since they are subject to the usual interpretational rules of the VCLT. By now, some states have introduced clarifications on what kind of measures should, under normal circumstances, not constitute a breach of the BIT. In the US Model BIT of 2004, Annex B, e.g., clarifies what measures should not count as a breach: “Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment do not constitute indirect expropriations.” The new Norwegian Draft Model BIT also retains the right to regulate in the public interest.⁷⁷ The latter is explicitly modeled on WTO law. WTO law allows states to take otherwise unlawful measures for pursuing public interest goals as, e.g., in Art. XX GATT, Art. XIV GATS or the Safeguards Agreement. Thereby, states are granted freedom of action for taking regulatory measures deemed to be in the public interest. Although those exceptions set high hurdles to be fulfilled, they nevertheless grant flexibility for regulatory measures taken in good faith.⁷⁸ IIAs up to now rarely contain similar provisions. This

⁷⁶ For a discussion concerning the US, see Raj Bhala, 'National Security and International Trade Law: What the GATT Says, and what the United States Does', 19 University of Pennsylvania Journal of International Economic Law 263 (1998).

⁷⁷ Art. 24 of the Norwegian Model BIT, above n 64, which is basically modeled on the General Exceptions in GATT and GATS.

⁷⁸ See the Chapeau of Art. XX GATT. For a discussion of the possibility of states to invoke non-trade law in trade disputes, e.g. environmental or human rights concerns or to regulate public health, see Gabrielle Marceau, 'WTO Dispute Settlement and Human Rights', 13 European Journal of International Law 753 (2002); Gabrielle Marceau/Joel Trachtman, 'The Technical Barriers to Trade Agreement, the Sanitary and Phytosanitary Measures Agreement, and the General Agreement on Tariffs and Trade', 36 Journal of World Trade 811 (2002) and more generally Joost Pauwelyn 'The Role of Public International Law in the WTO: How far Can we Go?' 95 American Journal of International Law 535 (2001); Joost Pauwelyn, *Conflict of Norms in Public International Law. How WTO Law Relates to Other Rules of International Law* (Cambridge: Cambridge University Press, 2003); Joost Pauwelyn, 'How to win a World Trade Organization Dispute Based on Non-World Trade Organization Law?' 37 Journal of World Trade 997 (2003); Joost Pauwelyn, 'WTO Compassion or Superiority Complex?: What to Make of the WTO Waiver for 'Conflict Diamonds'', 24 Michigan Journal of International Law 1177 (2003).

creates inflexibility for regulatory concerns of host states and may thus lead to an overcommitment.

3. Flexibility Through the Interpretation of Vague Terms

Flexibility of the IIAs may also be realized through the interpretation of vague terms. Huge parts of PIL are phrased in “soft” terms, allowing for adjustment to contingencies.⁷⁹ Also IIAs are drafted mostly in vague terms, especially concerning the protective provisions, thus delegating discretion to tribunals. This makes the interpretation of the tribunals crucial for an optimal balance between commitment and flexibility and ultimately for the stability of the system.

Generally speaking, if precision is high and the promise strict, then the flexibility costs would also be high. Therefore, states may prefer low precision *ex ante*, unless they feel that they can explicitly restrain certain protective norms without losing credibility. Hence, if precision is low, the flexibility costs depend crucially on the interpretation by the tribunal and a problem of unforeseen strict promises might arise. This is aggravated by the fact that most BITs have been concluded before the surge in arbitral decisions. It was clearly difficult for states to predict judicial outcomes of disputes with any degree of certainty and thus also difficult to know how rigid their commitments would be interpreted to be. Tribunals may be on the “flexibility” side by deferring to the regulatory policy decisions of host states giving them a bigger margin of appreciation. Or they may interpret treaties with a narrowly understood object and purpose of the BIT, that is, the investor’s protection only. The latter approach thus turns a contract *ex post* into a contract with “hard” terms which has a greater tendency to be inefficient from an *ex post* perspective.

Contract theory assumes disinterested third party adjudication; to my knowledge there is no literature in contract theory on the question of potential conflict of interests of courts or tribunals. It is, however, a well-known problem in investment arbitration. Some commentators diagnose a systemic problem of revolving doors between arbitrators and counsels.⁸⁰ Furthermore, so called “issue conflicts”⁸¹ may arise if the same person is at the same time an arbitrator in one case and a counsel for an investor in another case when the interpretation of the same substantive

⁷⁹ Most generally, Art. 62 of the VCLT above n.71.

⁸⁰ Thomas Buergenthal, 'The Proliferation of Disputes, Dispute Settlement Procedures and Respect for the Rule of Law', 3 Transnational Dispute Settlement; Online Journal 6, (2006). Arbitration Rule 6 of the new Arbitration rules of the ICSID Convention by now has indeed stricter conflict of interest rules for arbitrators.

⁸¹ Judith Levine, 'Dealing with Arbitrator "Issue Conflicts" in International Arbitration', 3 Transnational Dispute Management, Online Journal (2006).

norm is in question.⁸² Although this might be rather a perceived than a real problem, state parties should be aware of it. Wide discretion in the terms of a BIT thus leaves more room for interpretative extremes.

In practice, we find rather strict interpretation by ICSID Tribunals. In the view of some tribunals, BITs are instruments for the maximization of investor protection;⁸³ accordingly, uncertainties as to how to resolve ambiguous treaty provisions should be resolved in favor of foreign investors.⁸⁴ Lately, few arbitral tribunals or minority arbitrators have dismissed such an approach, calling instead for a more balanced interpretation which considers both the necessity to protect foreign investment and the state's sovereign responsibility to provide for 'an adapted and evolutionary framework for the development of economic activities'⁸⁵ and giving more margin of appreciation to states.⁸⁶ The United States contended, in a dispute where it was respondent that 'a doctrine of restrictive interpretation should be applied in investor-state disputes. In other words, wherever there is any ambiguity in clauses granting jurisdiction over disputes concerning states

⁸² States have only lately started to employ international law firms for investment cases which gave a strong incentive for law firms to cater to the interests of those which initiate a claim, that is, the investors.

⁸³ How narrow the object and purpose of a BIT is to be seen, is open to discussion but most tribunals take a narrow view, e.g. *Siemens A.G. v. The Argentine Republic* (ICSID Case No. ARB/02/8), Decision on Jurisdiction, August 3, 2004, para. 81: "The Tribunal shall be guided by the purpose of the Treaty as expressed in its title and preamble. It is a treaty "to protect" and "to promote" investments.... It is to create favorable conditions for investments and to stimulate private initiative". Nevertheless, some preambles (e.g. the US, Norway and Swiss Model BIT) reveal that the protection of investment is rather a means to an end, i.e. welfare, development or prosperity (of home and host states). The ICSID Convention was foremost set up under the auspices of the World Bank not in order to protect private property as such but in order to foster development. All those texts reveal a means-end relationship between investment and development. Schreuer, above n 23, Preamble, para. 11: "The ICSID Convention's 'primary aim is the promotion of economic development". Ibid. at Art. 25, para. 88: "Therefore, it may be argued that the Convention's object and purpose indicate that there should be some positive impact on development." Similarly, Prosper Weil invokes the purpose of the ICSID Convention in his dissenting opinion in *Tokios Tokelés v. Ukraine*, (ICSID Case No. Arb/02/18), Decision on Jurisdiction (29 April 2004), available at: <http://ita.law.uvic.ca/documents/Tokios-Jurisdiction_000.pdf> (visited 12 July 2008).

⁸⁴ See e.g. *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, (ICSID Case No. ARB/02/6) (29 January 2004) at para. 116: "It is legitimate to resolve uncertainties in its interpretation so as to favour the protection of covered investments."

⁸⁵ *Pan American Energy LLC and BP Argentina Exploration Company v. Argentine Republic*, (ICSID Case No. ARB/03/13), Decision on Preliminary Objections (27 July 2006) at para. 99 and *El Paso Energy International Company v. Argentine Republic*, (ICSID Case No. ARB/03/15), Decision on Jurisdiction (27 April 2006) at paras. 66 ff., para. 70: "a balanced interpretation is needed, taking into account both State sovereignty and the State's responsibility to create an adapted and evolutionary framework for the development of economic activities, and the necessity to protect foreign investment and its continuing flow", thus rejecting a one-sided interpretation either in favor of foreign investors or in favor of host states. See also *Noble Ventures, Inc. v. Romania*, (ICSID Case No. ARB/01/11) (12 October 2005), para. 52.

⁸⁶ E.g. *S.D. Myers, Inc. v. Government of Canada*, NAFTA by UNCITRAL Rules, 1st Partial Award (13 November 2000) para. 261 and 263; *Saluka Investments B.V. v. Czech Republic* (Partial Award) (17 March 2006), para. 304 f.

and private persons, such ambiguity is always to be resolved in favor of maintaining state sovereignty'.⁸⁷

IAs could be rendered more flexible by being more deferent to the regulatory policies of host states. Without being able to go into the details of possible flexibility in the interpretation of substantive BIT norms, two quick examples may suffice. The interpretation of “indirect” expropriation has been meandering between the so-called “sole effects doctrine”, i.e. only the effect of the measure on the property is looked at, and the inclusion of the regulatory purpose.⁸⁸ The inclusion of the latter allows for the application of the proportionality principle as e.g. the European Court of Human Rights (ECtHR) practices it for the European Convention for the Protection of Human Rights and Fundamental Freedoms⁸⁹ (Art. 1 of Protocol No. 1 for the right to property⁹⁰). The literature has taken up this idea from the Tecmed case,⁹¹ where the tribunal explicitly referred to the ECtHR jurisprudence.⁹²

Furthermore, in the context of fair and equitable treatment,⁹³ the reference points for judging the fairness and equitableness of a measure could, as it is interpreted now by the “reasonable expectations” of the investor, include regulatory purposes, since all states take measures in the public interest. No investor can reasonably expect that states freeze their public purpose regulation in the long term. Another method of rendering investment law more flexible in the light of non-investment law is through a harmonious interpretation of international legal obligations for states; just as it is done in WTO law. Art. 31 (3) (c) VCLT allows for the consideration of other international treaties concluded between the parties,⁹⁴ like international environmental treaties or human rights treaties may be taken into account when determining the obligations of states e.g. in the interpretation of indirect expropriation or fair and equitable

⁸⁷ *Methanex Corp. v. United States of America*, NAFTA by UNCITRAL Rules, 1st Partial Award (7 August 2002) para. 103.

⁸⁸ See above the literature cited in footnotes 16 and 17.

⁸⁹ European Convention for the Protection of Human Rights and Fundamental Freedoms, Rome, adopted 4 November 1950, entry into force 3 September 1953, 213 U.N.T.S 222.

⁹⁰ Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, Paris, adopted 20 March 1952, entry into force 18 May 1954, E.T.S 009.

⁹¹ Tecmed, above n 54, at para. 122: „There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.“

⁹² See Anne van Aaken, 'Fragmentation of International Law: The Case of International Investment Law', XVII Finnish Yearbook of International Law 91 (2008); Ursula Kriebaum, 'Regulatory Taking: Balancing the Interests of the Investor and the State', 8 Journal of World Investment and Trade 717 (2007); Ursula Kriebaum, *Eigentumsschutz im Völkerrecht* (Berlin: Duncker & Humblot, 2008).

⁹³ See above the literature cited in footnote 18.

⁹⁴ See extensively Campbell MacLachlan, 'The Principle of Systematic Integration and Article 31(3)(c) of the Vienna Convention', 54 International & Comparative Law Quarterly 279 (2005) at 280-281 who describes that interpretational method as the „master-key“ of constructing the large building of international law.

treatment. E.g., if a country chooses to introduce protective measures for indigenous tribes and restricts the investment, the application of the ILO Convention on Indigenous People could influence the interpretation of fair and equitable treatment as well as expropriation.⁹⁵ This kind of more flexible interpretation, however, is rarely found.⁹⁶

States may have an aversion to entering into too rigid commitments due to ensuing sovereignty costs, i.e. costs which are created by the restriction of possible action, e.g. certain regulatory measures cannot be taken or certain policies may not be allowed without due compensation (e.g. environmental measures, tax policy, or certain economic or monetary policy). This, in turn, gives rise to the inherent instability of investment protection.

V. The Participation Constraint of States

As we have seen, flexibility instruments are rather scarce in investment law in comparison to WTO law. Reactions by states due to learning effects are likely and they can already be diagnosed. Certainly, if states exit the system as a whole, they show that they deem investment law to have negative utility consequences for them. But “non-participation” comes in many and much more subtle forms some of which will be described below.

The first form is the most direct and explicit one: states may just stop entering into IIAs. Over the past 15 years, we have seen an ongoing surge in the conclusion of Bilateral Investment Treaties (BITs)⁹⁷ in absolute terms as well as a surge of international arbitration of investment disputes at around the same time.⁹⁸ Even though more than 2500 BITs have been concluded (although not all of them ratified), BITs by now, if a similar effect to that of a WTO Agreement covering investments would be desired, one would need 11,175 BITs (calculating with 150 WTO member states) in order to have a worldwide protection of investment, similar to the inclusiveness

⁹⁵ Submission of Non-Disputing Party Quechan Indian Nation (16 October 2006), *Glamis Gold Ltd v. The United States of America* <www.state.gov/s/l/c10986.htm> (visited 12 July 2008), at 8 *f.* Here, the potentially affected people by the investment project in question, a mine, assert that they are protected by *inter alia*, the 1966 International Covenant on Civil and Political Rights, the 1972 UNESCO Convention on World Cultural Heritage, the ILO 169 Convention on Indigenous and Tribal Peoples, and the Inter-American Convention on Human Rights.

⁹⁶ See for details van Aaken, above n 92.

⁹⁷ From 1990 to 2007, there is a surge from less than 500 BITs to 2608 BITs, see UNCTAD, above n 6, at 14. If investment chapters of regional trade agreements, such as NAFTA are included, there was even more treaty making activity in the investment protection area, at 16.

⁹⁸ Known investment treaty arbitrations surged from almost zero in 1994 to 290 by 2007, the majority of cases being conducted under ICSID. IIA Monitor No. 1 (2008), Latest Developments in Investor-State Dispute Settlement, UNCTAD/WEB/ITE/IIA/2008/3, http://www.unctad.org/en/docs/iteiia20083_en.pdf (visited 13 November 2008), at 1. The ICISD website registers 155 concluded cases (not all of them concluded by arbitration) and 125 pending cases as of January 12, 2009. Not all arbitrations are known, e.g. if they are conducted under UNCITRAL.

of WTO. Nevertheless, there is a considerable relative decline in the conclusion of BITs since the middle of the nineties with accelerating speed since 2002. Although the number of FTAs is surging and some of them contain investment chapters, the relative decline found in the conclusion of BITs is not offset.⁹⁹ This decline cannot be attributable to saturation as investment flows are not confined to a few countries only. Of course, concluding BITs might be subject to diminishing returns, e.g. a BIT with a small, distant country may not reap awards in the form of FDI. Nevertheless, if BITs are to be seen as a potential marketing instrument by states (signaling reliability), this marketing should reach all possible investors (and therefore countries). The decline occurs simultaneously with the surge of international arbitration based on BITs in the last fifteen years – we thus assume a learning effect.

Secondly, national parliaments or constituent assemblies may set up specific constraints that reduce the negotiating discretion for future governments to include specific provisions in BITs. A rather new phenomenon observed in some Latin American countries is that of constitutional amendments, restricting the future negotiation possibilities of governments. Although the (proposed) constitutional changes do not (yet) prohibit the conclusion of investment treaties as such, they do prescribe certain limits. In Ecuador, the Commission on Sovereignty Issues of the Constituent Assembly has recommended a provision forbidding the State from submitting its disputes to international arbitration. In a similar manner, the new Bolivian constitution, if it is accepted by a referendum in 2009, forbids in Art. 366 recourse to foreign tribunals or jurisdiction for investments in certain sectors.¹⁰⁰ These constitutional provisions do not apply retrospectively or to any dispute arising out of treaties ratified before a change of the constitution as from an international law perspective, a state may not invoke its internal laws, even constitutional, to invoke the invalidity of an international treaty.¹⁰¹ Nevertheless, such constitutional provisions will be a determining factor in all future negotiations of BITs as parliaments, which usually need to ratify IIAs, are bound by these provisions.

Thirdly, states may decide to exit the treaties either by not prolonging them or explicitly denouncing them. Most BITs are concluded for a certain period of time (e.g. 30 years with

⁹⁹ UNCTAD, above n 41, compare Fig. I.10 and I. 14 and p. 28. See also UNCTAD, 'Investment Provisions in Economic Integration Agreements' (Geneva/New York: UNCTAD, 2006).

¹⁰⁰ Art. 366: „Todas las empresas extranjeras que realicen actividades en la cadena productiva hidrocarburífera en nombre y representación del Estado estarán sometidas a la soberanía del Estado, a la dependencia de las leyes y de las autoridades del Estado. No se reconocerá en ningún caso tribunal ni jurisdicción extranjera y no podrán invocar situación excepcional alguna de arbitraje internacional, ni recurrir a reclamaciones diplomáticas.“ Available at: <http://www.repac.org.bo>.

¹⁰¹ Article 27 VCLT.

extension of the protection for another period of time, e.g. 10 years) with provisions for prolongation. Ecuador has been the first country to publicly announce that it may withdraw from its BITs as well as from the ICSID Convention.¹⁰² Some more countries have announced their intentions to withdraw from the ICSID Convention¹⁰³ or have already withdrawn, as Bolivia¹⁰⁴ has done. Exiting a treaty may be costly as it has higher a reputational effect¹⁰⁵ than when it is not prolonged or not entered into in the first place.

Fourthly, states may also choose non-compliance, although that may be even more costly for reputational reasons. Here, a state will calculate whether compliance now is more costly than losing foreign investment in the future. Argentina, e.g., announced first that it will not honor the ICSID awards in connection with the Argentine Crisis of 2000/2001,¹⁰⁶ although that statement was revoked for the decision on the staying of the CMS award.¹⁰⁷ Now, it has insisted that it will pay these awards but that claimants should present the awards to an Argentine court.¹⁰⁸ Since then, investment arbitrators take a more cautious stance.¹⁰⁹

More subtle ways of scaling down commitments considered too rigid are, of course, available and used. States may resort to writing more complete contracts either in new BITs or when re-negotiating BITs upholding flexibility, as states may not want to ratify BITs which restrict their sovereignty in an *unpredictable* manner. If states thought of giving a promise P_A at time 1 and find out at time 2 that they promised P_B (with P_B stricter than P_A), they might - through a learning process - react in the light of the experiences of too strict interpretation. Countries may

¹⁰² Susan D. Franck, 'Occidental Exploration & Production Co. v. Republic of Ecuador', 99 American Journal of International Law 675 (2005), and Investment Treaty News of 9 May 2007 concerning the termination of the US-Ecuador BIT. Ecuador notified under Article 25(4) of the Washington Convention that it intends to exempt oil and mining disputes from ICSID and Venezuela's Legislature called to withdraw from ICSID entirely.

¹⁰³ The Nicaragua Attorney General announced in April 2008 that his country might withdraw from ICSID, see <http://www-usa.laprensa.com.ni/archivo/2008/abril/14/noticias/economia/253728.shtml> (visited 12 January 2009).

¹⁰⁴ Bolivia submitted its notice of withdrawal from the ICSID Convention on May 2, 2007. In accordance with Art. 71 of the Convention, the denunciation took effect six months after the receipt of Bolivia's notice, i.e., on November 3, 2007. That does not mean though, that cases cannot be brought against Bolivia before ICSID under the Additional Facility Rules. Furthermore, as BITs have post-termination protection, the cases under dispute now might still be arbitrated under those BITs. The issues will most probably be clarified in a complaint procedure by *E.T.I. Euro Telecom International N.V. v. Republic of Bolivia* (ICSID Case No. ARB/07/28).

¹⁰⁵ See for an encompassing analysis, Laurence R. Helfer, 'Exiting Treaties', 91 Virginia Law Review 1579 (2005).

¹⁰⁶ See Osvaldo J. Marzorati, 'Argentina Opting Out?', 2 Transnational Dispute Management, Online Journal (2005).

¹⁰⁷ Decision on Argentine Republic's Request for a Continued Stay of Enforcement of the Award *CMS v. Argentina* (1 September 2006). This award has not yet been paid by Argentina.

¹⁰⁸ Investment Arbitration Reporter Vol.1, No.17, of 17 December 2008 concerning the case *Compañía de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Argentine Republic* (ICSID Case No. ARB/97/3).

¹⁰⁹ In the request for a Stay of the Enforcement of the Award in the Enron Case, above n 73, the committee took the view that a posting of security might be ordered in the Enron case, unless Argentina were to signal within 60 days that it takes a different view on its compliance obligations.

restrict the interpretational discretion of international tribunals, if they think that the net benefit of credible commitment is turning negative. They can do this in several ways, e.g. by watering down the substantive protection of foreign investors' rights when renegotiating BITs¹¹⁰ or when concluding new BITs.¹¹¹

One way of doing this is for states to write more complete contracts by clarifying indeterminate legal terms, such as "foreign investor",¹¹² "fair and equitable treatment", "indirect expropriation", and the scope of the MFN clause. They may, e.g., state that certain environmental or public security measures do not amount to indirect expropriation.¹¹³ Art. 139 (2) of the newly signed China-New Zealand Free Trade Agreement¹¹⁴ as well as Art. 4 (3) of the new draft Model BIT of Norway¹¹⁵ clarify that the MFN Clause is not meant to cover the procedural provisions and thus turn against the *Maffezini* Decision.¹¹⁶

A second way would be for states to exclude contentious protective provisions from the IIA. For example, the Economic Cooperation Agreement between India and Singapore of 2005, excluded the highly contentious provisions of "fair and equitable treatment" and the MFN clause. That, of course, means much less protection than is usual in BITs. The newly negotiated Trade

¹¹⁰ A growing number of BITs are being renegotiated. As many as 10 of the 44 (23%) BITs signed in 2007 replaced earlier treaties. This brought the total number of renegotiated BITs to 121 at the end of 2007. See UNCTAD, above n 6, at 15.

¹¹¹ As *ibid*, at 15 states, ever more countries are revising their model BITs to reflect new concerns related, for example, to environmental and social issues, and the host country's right to regulate. The same is true for negotiations of new BITs (e.g. one under way between Canada and China). As UNCTAD says: "a growing number of recent agreements mark a step towards a better balancing of the rights of foreign investors, on the one hand, and respect for legitimate public concerns on the other."

¹¹² *Tokios Tokeles v. Ukraine* above n.83. In a rare occurrence, the President of an ICSID arbitral tribunal, Prosper Weil, has dissented from this decision on jurisdiction and has signaled a concern for the "integrity" of the ICSID system, as the interpretation of the majority would ultimately allow nationals to seek protection against their own state in international tribunals. That, in his opinion, would destabilize the system as such and go against international law principles.

¹¹³ As e.g. in the new US Model BIT 2004 which restricts the interpretational discretion concerning indirect expropriation in Annex B considerably "Except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations." The same holds for the investment part of the Japan-Philippines Economic Partnership Agreement, <http://www.mofa.go.jp/region/asia-paci/philippine/epa0609/main.pdf>, (visited 13 November 2008) which states several exceptions and safeguards concerning regulatory issues (see Arts. 99 ff.).

¹¹⁴ '2. For greater certainty, the obligation in this Article does not encompass a requirement to extend to investors of the other Party dispute resolution procedures other than those set out in this Chapter.' A website with details of the agreement can be found at: <http://www.chinafta.govt.nz/> and the text of the agreement is at: <http://chinafta.govt.nz/1-The-agreement/2-Text-of-the-agreement/> (visited 13 November 2008).

¹¹⁵ <http://www.regjeringen.no/upload/NHD/Vedlegg/hoeringer/Utkast%20til%20modellavtale2.doc> (visited 13 November)

¹¹⁶ *Emilio Maffezini v. Kingdom of Spain*, (ICSID Case No. ARB/97/7), Decision on Jurisdiction (25 January 2000). On the development of the jurisprudence since Maffezini, see van Aaken, above n 21.

and Investment Pact between Japan and the Philippines as well as the US-Australian Free Trade Agreement all contain the usual substantive protective provisions but leave out the *ex ante* state consent to an investor-state arbitration mechanism.¹¹⁷

Another possibility is to restrict the interpretational supremacy of investment tribunals by including a general saving clause for interpretation of the treaty or by excluding judicial scrutiny for some provisions. As mentioned above, the US Model BIT of 2004 formulates the essential security clause as self-judging (“it considers necessary”).¹¹⁸ It is disputed, how far those kinds of clauses are non-justiciable and thus exempt from judicial review or are at a minimum to be reviewed in a residual good faith review.¹¹⁹ Furthermore, some BITs and FTAs do contain provisions which retain the final competence for interpretation by the states, e.g. NAFTA. As in WTO law,¹²⁰ State Parties have the ultimate say on how to interpret the norms of the treaty. The NAFTA Free Trade Commission has already made use of this provision and issued a binding statement in 2001 concerning the interpretation of “fair and equitable treatment”.¹²¹ It clarified that “fair and equitable treatment” as well as “full protection and security” do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens. The new draft Norwegian Model BIT of 2007 also uses this kind of mechanism.

Both mechanisms clearly restrict delegation to international tribunals and retain reaction possibilities for states. The advantage of such a device is that it can to a certain extent act as a

¹¹⁷ See Art. 107 Japan-Philippines Economic Partnership Agreement, <http://www.mofa.go.jp/region/asia-paci/philippine/epa0609/main.pdf> (visited 13 November 2008). See US-Australian FTA of May 18, 2004, http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Australia_FTA/Final_Text/asset_upload_file148_5168.pdf (visited 13 November 2008).

¹¹⁸ Article 18: Essential Security: „Nothing in this Treaty shall be construed: 1. to require a Party to furnish or allow access to any information the disclosure of which *it determines* to be contrary to its essential security interests; or 2. to preclude a Party from applying measures *that it considers necessary* for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.“ (emphasis added).

Also some newer US treaties, like the 2006 Peru-U.S Free Trade Agreement, signed on April 12, 2006, foresee auto-interpretation: Art. 22.2 with footnote 2 provides: “For greater certainty, if a Party invokes Article 22.2 in an arbitral proceeding initiated under Chapter Ten (Investment) or Chapter Twenty-One (Dispute Settlement), the tribunal or panel hearing the matter shall find that the exception applies.”

¹¹⁹ For an extensive discussion, see Burke-White and von Staden, above n 27, at 376 ff.

¹²⁰ Art. IX (2) WTO Agreement reserves the ultimate interpretational authority to a three-fourth majority of member states.

¹²¹ See “Free Trade Commission Clarifications Related to NAFTA Chapter 11,” July 31, 2001, <http://www.worldtradelaw.net/nafta/chap11interp.pdf> (visited 12 January 2009). The NAFTA member governments have reacted forcefully in a number of ways to their increasing liability under Chapter Eleven. On two occasions, they made joint policy statements about Chapter Eleven that could limit investors’ ability to bring claims. The United States has taken further steps in legislation and trade negotiations to ensure that the developments in some Chapter Eleven cases do not become institutionalized in future FTAs between the United States and other countries.

correction mechanism against tribunals' decisions. If tribunals fail to interpret contractual ambiguity in a way that state parties deem to be in their interest, the interpretation clause allows for possible "re-negotiation" within certain limits. This has the advantage of not endangering the stability of the contract as such, which a complete renegotiation (with all the transactions costs that this would encompass e.g. ratification by national parliaments) would entail. Of course, all State Parties to the treaty have to agree on a common interpretation of a treaty norm. But nevertheless this is a less costly and more subtle way than treaty renegotiation: it is a device for allowing for learning processes through a kind of functional renegotiation with low transactions costs and simultaneously mitigates the delegation problem of the state parties as arbitrators may expect the states' reactions. Since only a few BITs or FTAs preserve this binding interpretational competence for States,¹²² ultimate restriction for too investor friendly international tribunals (from the viewpoint of states) does not work everywhere.¹²³

Another way of restricting the scope of the treaties is to attach reservations either by a negative list or by a positive list approach for certain sectors. This is lauded by the UNCTAD as a key technique for balancing flexibility and regulatory autonomy of national authorities with their international commitments.¹²⁴ Reservations usually restrict the protective scope of the treaty for entire industries which makes them a very blunt instrument. This can be illuminated by the false positive/false negatives (type I and type II error) distinction. Generally speaking, legal errors can be divided into two categories. The first category of error is called type I error, or the "false positive", where meritless suits are allowed to be commenced, whereas type II errors, or "false negatives" keep legitimate claims out of court. Reservations tend to produce more „false negatives“ (assuming there is a meritorious case), because there is no protection whatsoever for the excluded sectors. A more restrictive and flexible interpretation by tribunals, taking into account, e.g., uncertainty and sensitivities in highly politicized and problematic sectors such as natural resources extraction and public utilities might be a better way to reduce such errors, since they still allow legitimate claims (false negatives are reduced). That would better optimize the error quote than a blanket exclusion of whole sectors would.

¹²² Whereas the US model BIT does, the European BITs generally do not.

¹²³ Generally, it would be worthwhile to conduct research on the question how such a provision may change international tribunals or courts behavior, depending on the number of treaty parties and majority requirements for changing the treaty.

¹²⁴ UNCTAD, *Preserving Flexibility in IIAs: The Use of Reservations*, (Geneva/New York: UNCTAD 2006).

VI. Conclusion and Outlook

One example of effective PIL is the case of international investment protection. But this effectiveness is subject to perils, namely that states could wish to weaken the system in order not to incur too high sovereignty costs. We therefore face a dilemma: international investment law could become too rigid from the viewpoint of states which may lead to lesser protection of investors in the long run. The point of optimality between commitment and flexibility still needs to be found. States' participation constraint comes into play as soon as the net benefit of giving credible commitments to investors equals or is below zero (*ex ante* or *ex post*). It may well be the case that certain host countries – competing with other countries for scarce capital – cannot afford to lower the standards of protection. But it would be short sighted to rely on that.

These arguments are not limited to developing countries alone. Ever more, capital flows from transition or developing countries such as Russia, China, India and Brazil to the OECD countries (or other developing countries). It seems that only the US and Canada have gone through a learning process with the NAFTA, being the defendant states in many cases and changing their Model BITs accordingly by making them more precise and giving less leeway to arbitral tribunals. Norway has followed this through its new Model BIT. Until now, Western European states have been largely spared from being a defendant in investor-states disputes (with the exception of the European transition countries). That might change soon under the Energy Charter Treaty which also provides for investor-to-state dispute settlement, energy policy being a highly contested field. Furthermore, it is still open in how far the various bail-out measures have violated the national treatment requirements in the BITs. It might well be that then those countries might also become more cautious in negotiating BITs that restrict sovereignty too much once they realize that the reciprocity of those treaties exists not only *de iure* but also *de facto*.

It is no coincidence that minority opinions in arbitral awards do issue warnings of destroying the system if the interpretation is stretched too far. Overprotection by too strict commitments *ex ante* or too strict protection by interpretation *ex post* may lead to reactions of states which will weaken international investment protection in the long run – a normatively undesirable outcome. Taking good faith measures of host states out of the extra-legal realm would grant not only more legal security to investors but also return credibility to the regime as such. Flexibility can not only be achieved through renegotiation, following the example of the US, Canada and Norway but also through sensible interpretation.

