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Issues with investment treaties and a suggestion on how to change the calculation of compensation

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Summary

This paper examines whether investment treaties impose too much constraints on host states actions and if that is the case, what can be done to remedy that issue. This is done by providing an oversight of the applicable rules that stem from the investment treaties and then discussing a few controversial awards originating from international arbitration. The international investment regime has been criticized in a number of ways, a few of the common arguments against the regime are taken into consideration. Lastly, this paper offers a suggestion on why and how to modify the current regime in a way which tries to remedy some of the criticism while still offering acceptable protection for the investor.

Sammanfattning

Denna uppsats undersöker huruvida investeringsavtal innebär för mycket begränsningar för värdländernas handlingar och om så är fallet, vad som kan göras för att åtgärda problemet. Uppsatsen erbjuder en översikt över några vanliga gällande regler som återfinns i investeringsavtal och går sedan vidare med att diskutera några internationella skiljedomar. Internationella investeringsavtal har kritiserats på flera olika punkter, en del av kritiken kommer att tas upp och beaktas. Slutligen erbjuder uppsaten ett förslag på varför och hur en skulle kunna ändra det nuvarande systemet på ett sätt som försöker åtgärda en del av kritiken och samtidigt erbjuda ett godtagbart skydd för investeraren.

1. Introduction

1.1 Background and purpose

Should a foreign investor be able to sue a host state in an international forum, if the state changes its laws in a way which is unfavorable for the investor? Concerns have been voiced that the framework applicable for foreign investors gives them too much power, and that the ability to sue in an international forum gives the states lower incentive to change their laws for fear of paying a large sum of money in compensation to the investors. These concerns have been raised, *inter alia*, in the ongoing process *Philip Morris Asia Limited v. The Commonwealth of Australia*. In this case the democratically elected state representatives decided to pass a law which in detail regulates the appearances of tobacco packaging, in a way unfavorable for the tobacco companies.

A necessity for Philip Morris to be able to sue Australia in an international forum is the existence of an investment treaty or Bilateral Trade Agreement (BIT) which includes an *investor-state arbitration* clause. A BIT is a treaty between two states in which legal rights are given to a third party, the investor.[1] In the absence of a BIT, the investor would be forced to turn to its home nation for diplomatic protection. Of course, resorting to diplomatic protection means that the investor has to rely on its home-states benevolence.[2] In the following chapters I will discuss the major problem that the BITs set out to solve, but also the problems which in turn is introduced by the BITs.

1.2 The Problem

When an investor considers making an investment in Country X, the investor needs to look at the current regulations offered by Country X. Country X might be very investor-friendly in the sense that it wants, and needs, investors to invest in the country. Therefore, its internal regulations provide favorable conditions for foreign investors, for example by low or absent income tax. The investor, seeing that the other relevant conditions (weather, terrain, natural resources and so forth) also favor him or her, might be very tempted to make a commitment

[1] Evans, Malcom (eds.) *International Law.* Oxford: Oxford University Press, 2014. pp. 741-746.

[2] Evans, 2014, p. 747.

and invest in Country X, relying on these favorable regulations promised by Country X. But the investor must also consider the following: the investment is most likely associated with several startup costs, with the effect that once the investment has been made it might not be economically viable for the investor to abandon the investment. Once invested, the investor makes a long time commitment to its investments, and also to Country X.

Country X knows this, so the question is: what stops Country X from luring with promises of no taxation in order to attract investments, but once the investments have been made the country removes the favorable regulations which attracted the investors in the first place? Country X can benefit from the fact that it is not economically viable for the investors to abandon their investments once the investments have been made. The country has the opportunity to change its regulations in favor of its own interest and in the disfavor of the investors interest to a certain degree without losing the investment.

Even if Country X has no intention of doing this, the investors know that Country X *can* do this, and if Country X cannot provide some kind of mechanism of trust, the investors might choose not to invest for fear of Country X later abandoning its investor-favorable regulations.

To solve this problem, which earlier has been called ”the dynamic inconsistency problem”[3] or ”the problem of obsolescent bargains”[4] (henceforth, "the dynamic inconsistency problem"), Country X signs an investment treaty. By signing an investment treaty Country X obliges to appear at an international court if so requested by the investors, and Country X also obliges to concur with a certain *treatment* of the investors and/or the investment. This treatment is vaguely defined in the investment treaties through mainly two means: by *a general treatment standard* and through regulations regarding *expropriation*.

For the sake of clarity, it is important to note that the problem appears in two different but similar situations: the state and the investor might be in negotiations directly, but they can also be negotiating only "indirectly". An example of the direct negotiations is when a state wants

[3] Guzman, Andrew. *Explaining The Popularity Of Bilateral Investment Treaties*. Oxford University Press; 2009. E-book. pp. 5.

[4] Salacuse, Jeswald. *The Law of Investment Treaties*. Oxford: Oxford University Press, 2010. pp. 271.

to let an investor operate public services, while an example of the latter is if a state tries to promote investment by letting everyone who fulfills certain criteria establish themselves under favorable conditions. In the latter case, the investor would not establish a contract with the state, thus the relationship between investor and state is governed by law, which the state can unilaterally alter.

The treaty tries so solve the above mentioned problem by giving a mechanism of control to the investor through investor-state arbitration and obligations imposed on the host state to treat the investor in a certain way. Should the host state not fulfill its obligations the state can be hold liable and compensation will need to be paid. The question this paper will examine is whether the treaties impose too much constraints on the host countries actions, and if that turns out to be the case, how the investment treaty could be modified while still offering acceptable protection for the investors.

1.3 Method

This paper will mainly be utilizing the method of legal dogmatics, which could be defined as using interpretation on generally accepted sources of law as a way to analyze a certain issue or field of law.[5] In the international context the sources of law is foremost international custom, general principles of law and treaties.[6] Awards from different courts and from international arbitrations may also be seen as sources of law, but their status is debatable, especially in the context of international investment law.

The first questions my paper will examine in regards to the problem mentioned above is: which are the applicable rules, where do they come from and what do they entail? This will be done solely through the legal dogmatic method, by arbitrations awards and through interpretations of standards found in international treaties. With that said, the subject of international law differs somewhat from domestic systems, and the method of legal dogmatics might not always be applicable in the same sense as when dealing with domestics systems. The existence of international custom, where one needs to find an *opinio juris* to verify the

[5] Korling, Fredric and Zamboni, Mauro (eds.). *Juridisk metodlära.* Lund: Studentlitteratur AB, 2013. pp. 21.

[6] Evans, 2014, p. 91.

existence of an international rule is to some extent a method of its own.[7] In effect, I will be studying academic papers much further than if one would use the same method in for example a Swedish domestic context.

1.4 Current research

There are several textbooks to choose from if one wishes to get a general overview of the international investment law regime, for example *The Law of investment treaties* by Jeswald W. Salacuse or *Principles of International Investment Law* by Rudolf Dozer and Christoph Schreuer. With that said, this paper will look at certain elements within that regime, and getting an overview of the literature regarding those elements are harder. That does not mean that there is a lack of academic literature, but this literature is to be found in different publications such as *The European Journal of International Law* rather than in book-form. While studying this subject I have read several articles from different publications, some which I will reference to and others for inspirational purposes. One thing can be said of this kind of literature, and that is that many have a political agenda and the reasoning contained is often based on arguments rather than on empirical studies. There seems to be a lack of empiricism in regards to the issues at hand, unfortunately this paper will not be able to remedy this as collecting empiric data in this field is a huge undertaking.

1.5 Disposition

This paper will begin with an overview of the history of investment law and a section on some of the more common contents of an investment treaty. Following that section will be an overview of some of the criticism against the investment treaties. Lastly I will present an alternative method, namely a modification to the BITs which I will argue solves some of the problems introduced by the BITs while still managing the original problem to a satisfying degree.

[7] Evans, 2014, p. 98.

2. International investment law

The body of international investment law consists of treaty based law as well as international custom. The treaty based law takes many forms, including Bilateral Investments Treaties (BITs), multilateral conventions and Free Trade Agreements (FTAs). This is only to mention a few, but the differences is mostly in name only. Of course, a BIT has per definition only two parties whereas the other forms can consist of multiple parties. The rules in these different treaties are, on the other hand, quite similar.[8]

When examining which are the applicable rules, and what they involve, treaty based law offers some guidance through the treaties themselves. But often one has to look at international custom when interpreting certain terms and expressions in the treaty.[9]

2.1 Overview of the history of international investment law

The history of international investment law is one of conflict where two principles have stood against each other.. The first principle is called the *principle of equality,* which says that a host state needs to treat foreign investors in the same way as it treats its domestic investors. It also states that the state has no further obligations against foreign investors than it has against its own nationals. This principle was supported by Mexican foreign minister Eduardo Hay in a much quoted correspondence with US Secretary Cordell Hull in the 1930s, and stands in stark contrast to the principle put forward by Hull, which is the idea of the *international minimum standard.* This latter principle or idea says that there is a certain level of treatment that is mandatory to uphold against foreign investors, even if this means that the host country needs to treat them better than their own nationals.[10]

Both these principles were clearly biased, suiting the needs of the countries supporting them. The developed countries, also called the capital exporting countries, favored the principle of the international minimum standards as these countries, and their nationals, had the most to

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[8] Salacuse, 2010, pp. 43.

[9] See art 31 in the *Vienna Convention on the law of treaties.*

[10] Salacuse, 2010, pp. 49.

gain from it. They argued that even though it was not in their power nor in their interest to regulate how other countries treated their own nationals, it was in their interest (and to some extent, also in their power) to secure that the investments made by the capital exporting countries own nationals were protected by at least the international minimum standard. Its existence were dependent on however such a rule was to be found in international custom, and indeed many countries (foremost the U.S.) argued that the rule were applicable and acted accordingly.[11]

But just as some countries argued forcibly that the rule was part of international law, with the same fervor other countries denied it. As mentioned earlier, Mexico was one of those countries which resisted the idea of an international minimum standard. Most of the Latin-American countries, the post-colonial countries and the Soviet resisted the minimum standard and proposed their own view on the issue, which often had its roots in the principle of equality mentioned above. This battle between the two principles resulted in uncertainty regarding the applicable rules.[12]

Some authors argue that this legal vacuum was the reason behind the increasing popularity of BITs and other treaties which regulated foreign investments.[13] But the author Andrew T. Guzman offers another perspective on the situation, arguing that the capital importing countries have very different incentives depending on whether they are acting as group or as individuals. Guzman notes that when the capital importing countries acts a collective, which they can do (and did) in the United Nations General Assembly, the collective can maximize their gains by resisting the international minimum standard and instead supporting a regime which gives the countries unconditional control of their territory and resources. But when the countries act individually, the playing field changes drastically. Now the other capital importing countries are no longer their allies, they are their competitors. Since the market according to Guzman is competitive in favor of the investors, the capital importing countries need to lure the investors to them and by signing a BIT they can give the investors a

[11] Evans, 2014, p. 729.

[12] Salacuse, 2010, pp. 62-75.

[13] Salacuse, 2010, p. 77.

mechanism which lets them make sure that the host state keeps it promises. This is intended to give them an advantage over other countries which lack a BIT.[14]

2.2 The content of an investment treaty

It is important to note that investment treaties and BITs do not simply establish the international minimum standard. The protection provided by the treaties goes further than the international minimum standard ever did, the most important difference is arguably the fact that treaties often include an *investor-state arbitration clause*. This clause gives the foreign investor the right to bring claims directly against the home state through international arbitration, while under the regime of the international minimum standard the investor had to rely on their home state press claims against the host country. Indeed, under the international minimum standard it is the home state which has exclusive rights, and even if a state would decide to press claims in favor of the investor, any compensation paid goes to the home state, and not the investor. The investor is not a part of the dispute.[15]

By including an investor-state arbitration clause in the BIT, the home country does not need to act at all in case of a dispute between host state and investor. This is a huge advantage for the investor, since the states and investors interests might not correspond. Even if the country would see the investors claim as legitimate, they might choose not to pursue it because of political reasons. This effect is called the depoliticization of the investment law, and it has been argued that this is one of the main reason BITs gained such popularity in the first place.[16]

2.2.1 Treatment standards

The treaty often includes *general standards of treatment* as well as *specific treatment standards*, the latter in regards to, *inter alia,* monetary transfers and expropriation. The general standard of treatment consist of two kinds: *absolute standards* and *relative standards*. The absolute standards, such as *fair and equitable treatment* or *guarantees of full protection and security*, sets a minimal standard

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[14] Guzman, 2009. pp. 1-25.

[15] Salacuse, 2010, p. 93.

[16] Sattorova, Mavluda. Return to the Local Remedies Rule in European BITs? Power (Inequalities), Dispute Settlement and Change in Investment Treaty Law. *Legal Issues of Economic Integration* 39, no 2 (2012). p. 226.

of treatment that the contracting parties must uphold. Exactly which level of treatment the different terms corresponds to has been the subject of debate, but there is some guidance to be found in commentaries, state practice and arbitral awards.[17]

The level of protection offered by the standard of fair and equitable treatment is very interesting for the dynamic inconsistency problem since this standard imposes *boundaries* on the host states actions. This section I will begin by borrowing some appropriate words from Jeswald Salacuse regarding three problems with interpreting the clause:

> First the term 'fair and equitable' is, one may say without exaggeration, maddeningly vague, frustratingly general and treacherously elastic. Second, the treaty provisions and the agreements in which the terms are embedded offer no definition for them, nor any real guidance on how to apply them. Third, despite the abundant scholarly commentary on the subject and a growing volume of arbitral decisions, application of the fair and equitable standard is so tied to the facts of the specific cases as to limit the utility of the arbitral decisions and doctrinal analysis.[18]

With that said, some principles have commonly been used in the arbitrators reasoning as to whether a states practice has violated the fair and equitable standard or not. Salacuse has identified five principles commonly used by arbitrators when examining state actions. Has the state: ”(1) failed to protect the investor's legitimate expectations; (2) failed to act transparently; (3) acted arbitrarily or subjected the investor to discriminatory treatment; (4) denied the investor access to justice or procedural due process; or (5) acted in bad faith”?[19]

Let us have a short look at (1), *the principle of legitimate expectations*. The expectations can originate from the host states laws, regulations or other actions taken during the pre-investment phase. By creating expectations through favorable regulations, the host state commits not to change or alter the favorable regulation to such a degree that they no longer correspond to the investors legitimate expectations. On the other hand, it is not required for the state to freeze its legal system either, instead one needs to inquire about the states

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[17] Salacuse, 2010, pp. 131.

[18] Salacuse, 2010, pp. 221.

[19] Salacuse, 2010, pp. 230.

reasonable right to regulate and the investors reasonable expectations. To discern whether the expectations are *legitimate expectations* one needs to discern if the action falls within the concept of reasonable regulations. For example, bringing ”environmental regulations [up] to internationally accepted standards”[20] constitutes a reasonable regulation, ergo such an action would not constitute a breach against the principle of respecting investors legitimate expectations.

The relative standards includes the MFN-clause mentioned above and the national treatment clause. These are relative in the sense that they do not set a certain standard of treatment or conduct, instead they are intended to guarantee that the investor will not be treated worse than either another foreign investor or a national of the host country. The national treatment clause states that the investor will not be treated worse than the host states own nationals. The most favored nation clause on the other hand states that an investor will not be treated worse than any other foreign investor.[21]

2.2.2 Regulations regarding expropriation

Expropriation is allowed, assuming that it fulfills certain criteria. The "Hull Formula”, which states that payment must be ”prompt, adequate and effective”, is commonly used in BITs and other investment treaties.[22] Further, it must be ”for a purpose which is in the public interest”, not be discriminatory and done in accordance with due process of law.[23]

Direct expropriation today is rather uncommon (or at least not very problematic), but indirect expropriation presents a few difficulties. Direct expropriation includes a taking of property, where the property at hand can constitute a material object as well as, *inter alia,* intellectual property and contractual property. Indirect expropriation is when the host state is using its regulatory or legislative powers to derive benefits from the investor and claim these benefits for themselves, without change to the legal relationship between the investor and the

[20] Salacuse, 2010, p. 233.

[21] Salacuse, 2010, p 133.

[22] Salacuse, 2010, p. 135.

[23] Salacuse, 2010, p. 289.

investment.[24] When determining whether an action constitutes indirect expropriation or not the arbitrators usually focus more on the effects the alleged action has on the investment, than on the intent of the host state or the form of the action.[25]

An example of indirect expropriation could be that through elevating taxes and fees removing any possible profits from the investment, thus removing any reason to actually own it. Usually the host state would deny that indirect expropriation is even taking place, but if an investor sues the host state through investor-state arbitration and the arbitrators finds that an indirect expropriation is indeed occurring, ”prompt, adequate and effective” compensation will have to be paid for the investors expenses.

[24] Salacuse, 2010, p. 297.

[25] Salacuse, 2010, p. 298.

3. Criticism against the investment treaties

Investment treaties have been attacked on at least three fronts:

1. The arbitration system is biased.
2. The substantive rules in the treaties impose too much constraint on the host states actions.
3. The financial costs are too high, both in regards to the compensation and to the costs for the proceedings.

Basically, criticism has been raised in regards to the entire system of treaty based international investment law. To make matters even worse, it has been claimed that the system fails at its very purpose; to promote investment. This is a question which one should be able to resolve through empiric studies, but the studies made have been criticized.[26] In light of this I will leave that argument untouched, instead I will assume for the sake of argument that investment treaties indeed do promote investment.

3.1 Criticism against the arbitration system

The strongest criticism against the arbitration system in my view is that it is biased in favor of the developed countries.[27] On a further note, not just the arbitration system but many BIT themselves favor the developed party, for example by excluding many important sectors from the scope of the investment treaty within the developed states jurisdiction but not within the developing states jurisdiction.[28]

Another issue is the structure of ICSID, where the majority of the investor-state disputes are settled, and the fact that most BITs let the investor choose arbitration method, thus enabling them to force countries into ICSID arbitration rather than ad hoc arbitration. There are two

[26] Van Harten, Guz. Five Justifications For Investment Treaties: A Critical Discussion. *Trade, Law and Development,* Vol II:19 (Spring 2010). pp. 28-35.

[27] Sattorova, 2012, p. 229.

[28] Van Harten, 2010, pp. 42-45.

elements common to domestic systems which are lacking in international arbitration: the possibility to appeal and prejudicial awards. One could argue that these two components should be (better) implemented into ICSID, and even though I can certainly see the appeal I believe there is a reason for the these components being excluded from the system. ICSID helps the parties with the arbitration, but it is not ICSID that is responsible for the awards, the arbitrators are. In a sense, this is part of the problem, but it is also a way of ensuring that the parties get a neutral process. If one were to introduce an institute where the institute were responsible for the awards, and where the above mentioned components were implemented, one would be creating an international court of justice only dealing with investment law. There would always be a suspicion that such an institute would have a hidden agenda of trying to make all other countries adhere to the creators domestic law and/or political policies. By keeping the institute and arbitrators separate, one can avoid such criticism.

Moreover, the investor-arbitration clause has caused commotion since some countries think it is unreasonable to grant rights to foreign investors not available to domestic investors. This has led countries to reject investor-state arbitration.[29] Australia rejected this system because Australia does not want to be sued by investors through investor-state arbitration, most notably is the Philip Morris case which is the source of some controversy. But by rejecting this clause, Australian investors will lose the protection that investor-arbitrations grants them. While I agree that it seems unfair to grant foreign investors rights which are not available to domestic investors, I believe that abandoning the investor-state arbitration system comes at too high a cost. In an ideal world, all domestic courts would be free from corruption and would without exemptions apply the rule of law. But until that point, I would say arbitration is not a bad option (even though the system surrounding it today could use some improvements). The goal of international arbitration should be to uphold an international minimum standard of due process, granting foreign investors the option to choose whether to rely on the domestic courts or international arbitration. But for this to work properly (not making foreign investors choose international arbitration as standard) the arbitration system needs to get rid of its reputation as biased in favor of investors (and capital exporting countries). And I see no reason not to include a clause in the BIT which forces the investor to

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[29] Trakman, Leon. Investor State Arbitration or Local Courts: Will Australia Set a New Trend? *Journal of World Trade* 46, no 1 (2012). p 85.

exhaust local remedies first,[30] possibly combined with certain other conditions which let the arbitrators reject a claim if they find that justice has been found during the domestic process but also conditions which let an investor bypass local remedies if it can be shown that the investor can not find justice through those means, for example if the process is too slow.[31]

3.2 Criticism against the substantive rules in the investment treaties

There is a fear that the rules in the investment treaties impose too much constraint on the host states actions. This impedes the possibility for the state to improve its internal legalization, to such a degree that it might be harmful for the state and its citizens.[32] Some of the rules one might refer to in this instance is those regarding expropriation (direct and indirect, "creeping" and partial) and the general treatment standards, most notably the fair and equitable standard. The scope of these provisions is not entirely clear, and though interesting there is not enough room to discuss that issue here.

The problem is twofold: there is a fear that these provisions impose too much constraint on the host state actions in themselves, but there is also the fear that the host state chooses *not* to implement certain legislation (which would benefit its citizens), fearing that new legislation could provide a breach of the investment treaty.[33] This latter mentioned problem is one of theory only, since there has been no empirical survey regarding this issue as far as I know. Nevertheless, the fact that the scope of some of the provisions in the investment treaty are unclear could very well have an impact on how states use their legislative power. Indeed, if one were to say that investment treaties in general do not affect the host states use of its legislative power, there would almost be no point in signing investment treaties.

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[30] A clause which is common but not always included in BITs. See Sattorova, 2012.

[31] Justice delayed is justice denied, but one should note that even ICSID arbitration has been criticized for being a lengthy process.

[32] See Chinen, Mark. Complexity Theory and the Horizontal and Vertical Dimensions of State Responsibility. *The European Journal of International Law.* Vol. 25 no. 3 (2014).

[33] Salacuse, 2010, p.121.

There are two solutions, according to me, to these above mentioned two problems: either one changes the substantive rules in a way which is satisfactory, and then one needs a system to make sure that the rules are applied in a consistent manner. This might be a larger issue, one which leads us back to the problems with the current state international arbitration. Unless the treaty is unquestionably clear (can there be such a thing?) the treaties will need to be interpreted, and since there is no obligation for an arbitrator to follow an earlier award there is no way to ensure that the interpretation will be predictable and consistent.

The second solution is maybe not so much a solution as a remedy, and that is a change in the calculation of compensation. This idea will be elaborated further on, but the concept is that in lowering the amount of compensation that the host state needs to pay when it has been settled that a treaty breach has occurred, one remedies both of the above mentioned two problems. A state which faces the problem that it does not know whether it's new legislation might constitute a treaty breach is encouraged to legislate in the modified system when compared to the current system. Of course, the compensation cannot be lowered in all cases, since that might allow a state to ignore the system entirely (for example by introducing new legislation that will increase the taxes in a way which constitutes a breach of the treaty, since if compensation is not paid in full in such a scenario the state will always increase its cash flow and there will never be a financial reason for the state not to breach the treaty).

3.3 Criticism against the costs of investor-state arbitration

Authors have argued against a regime of international investment law in its current form, based on the idea that the investment treaties impede the host countries ability to change its laws, consequently making it harder for the country to improve, *inter alia*, the working conditions for the workers or the protection for the environment.[34] The main issue is in regard to the ability for the investor to sue a host state through international arbitration, and that the investor through these means might be able to get a considerable amount of compensation. The protection that the investor gains can potentially be very costly for the host country.

[34] See for example Choudhury, Barnali. Recapturing Public Power: Is Investment Arbitration's Engagement of the Public Interest Contributing to the Democratic Deficit? *Vanderbilt Journal Of Transnational Law*. Vol. 41:775 (2008) especially pp. 792-797 and Van Harten, 2010.

The costs associated with investor-arbitration are of different character. For starters, there is the issue of the costs for the procedure and the legal representation. These costs in themselves can be notoriously high, one of the extreme cases being *CME Czech Republic B.V. v. The Czech Republic* in which the Czech Republic allegedly spent US$ 10 million on its legal defense alone. But even when looking at a case which might be more representative, for example *Int'l Thunderbird Gaming Corp v United Mexican States*, the figures are far from low. In this latter mentioned case the costs for the proceedings, including the legal representation of both sides and arbitrators fees, was US$ 3.17 million.[35]

The main threat an investor can use against the host country is that it better behave, otherwise it is going to be costly. Regarding this threat from the investor, there is the fact that the procedure itself is costly. On the other hand, this is a costly process for the investor as well. So even though the costs of the procedure of course will add to the sum of all the costs in the end, this is balanced by the fact that it is a costly process for the investor as much as for the host state, encouraging him or her not to sue in the first place. This means that even though the high costs of the process are problematic in many ways, when it comes to its effects on the dynamic inconsistency problem these effects might not be too severe.

The costs for the proceedings (arbitration fees, legal representation) have been criticized for being too high.[36] This is an unnecessary expense both on the part of the investor as well as the host state. In effect, it also closes the door for many investment disputes on two grounds: 1. there must be a certain amount of expected payoff, otherwise it will no longer be profitable for the investor (the risk might be too high in regard to the possible earnings) and 2. investors might not afford these high costs even though they expect to win the award.

The other problem in regard to the costs is that the amount of compensation that the host state needs to pay in case of a treaty breach can reach notoriously high sums, one of the most controversial being *CME Czech Republic B.V. v. The Czech Republic* where the host state had to

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[35] Salacuse, 2010, p. 119.

[36] Salacuse, 2010, p. 119.

pay US$ 269 million in compensation.[37] This case is controversial not only because of the high compensation, but also because there was a second proceeding with the same parties and the same circumstances, *Ronald S. Lauder v. The Czech Republic*. This second proceeding was not dismissed because of *res judicata*, instead the same circumstances was tried twice. But in the second proceeding, the claimant lost. Other awards where the claimant won high amounts of compensation are *Occidental Petroleum Corp. v. Ecuador* (US$ 1.7 billion), *CMS Gas Transmission Co. v. Argentina* (US$ 133.2 million) and *Ioan Micula and others v. Romania* (US$ 99 million). These high sums can damage the legitimacy of the investment law regime, especially if one also considers that the investor-state arbitration system has been criticized for being biased in favor of the investors.[38] But not only can the awards amount to ridiculously high sums, the arbitrators have been further criticized for not applying any valuation standards when evaluating damages consistently.[39]

[37] Crawford, James. Ten investment arbitration awards that Shook the World: Introduction and Overview. *Dispute Resolution International.* Vol. 4 no. 1 (May 2010) p. 94.

[38] Van Harten, 2010, pp. 40-41.

[39] See Pan, Jason. Valuation Standards for Calculating ICSID Awards. *Pepperdine Dispute Resolution Law Journal,* Vol 14:355 (2014).

4. Suggestions and Conclusion

4.1 Suggestions on how to change the system

First, one needs a consistent system in regard to the valuation of assets. Author Pan (2014) suggests the so called ”White Book”, which is maintained by *The International Valuation Standards Council***.** I see no reason not to apply these rules, but I must stress the fact that the important part is that the arbitrators choose to apply *any* rules consistently. This so that both investors and states may predict the costs and benefits of investor-state arbitration.

Secondly, I would recommend introducing a new clause in the international investment treaties, which says not only that arbitrators *may* but that they *should* lower the amount of compensation to be paid should the amount be so high that it can be viewed as *an adequate damage* to the host state. This means that whether the compensations is to be considered an adequate damage or not one needs to look at the host state resources and financial situation. Of course it is the host state which would need to prove this. Hopefully this does not need to include too much trouble, I can image that the question could be settled by examining *inter alia* the country's public state budget and other official documents.

Unfortunately, there is a risk that the clause would be used arbitrarily by the arbitrators. To some degree this is unavoidable, but I would recommend that the treaty include a description of different factors that the arbitrators should consider when evaluating whether the compensation constitutes an adequate damage or not. For the sake of flexibility, I do not believe that it is possible to introduce such a rule without leaving some room for the arbitrators discretion. This also means that how much the compensation should be lowered will also be at the arbitrators discretion, but the intention is that it should be lowered until it no longer constitutes an adequate damage for the host state.

By introducing the above mentioned clause into the treaties one could potentially deal with some of the criticism against investor-state arbitration. One of the issues this modification deals with is the problem with host states neglecting to use their legislative power for the benefits of its citizens. As mentioned, there is a fear that the rules in the investment treaties impede the host state actions too much, the state fearing reprisals if their new legislation would constitute a breach of an investment treaty. For example, when determining whether there has been a breach of the fair and equitable treatment standard, one looks at the investors *legitimate expectations.* One can easily imagine a situation in which a host state considers new legislation which is unfavorable for the investor but which benefits the states citizens. My intentions are that in such a scenario, where it is unsure whether the new legislation would constitute a breach of the principle of legitimate expectations (and thus constituting a treaty breach), the host state now feels that the risk of the new legislation is worth taking, considering that even if a breach occurs it no longer has to fear that it will be forced to pay a very high amount of compensation. By lowering the compensation the state is encouraged (to some extent) to disregard the treaty, and can act and utilize its legislative powers in a way that the state finds most efficient. But it still needs to consider the treaty, since there is still the risk that they might be sued and be forced to pay compensation. But this is also the protection required by investors, otherwise the treaties would be null. Plenty of investors would still be protected by the treaties since in most cases the amount of compensation would not constitute an adequate damage to the host state. This would also add another factor for the investor to consider when he or she decide whether to invest in a country or not, should the investment be very large and the country's economy limited, there is a substantial risk for the investor that it might not get full compensation paid in case of a dispute between the investor and the host-state. But on the other hand, in these scenarios there is a chance that the investment might be considered so important for the host-state that the state and the investor comes to an agreement that any compensation should be paid in full. Ergo, a contract (which changes the rules regarding the calculation of compensation) between an investor and a state should still apply even if its rules were contradictory to the rules in the investment treaty. But in this scenario, it is easier for the host state to do a thorough cost and benefit analysis before signing a contract.

My suggestion is primarily introduced to deal with cases like *CME Czech Republic B.V. v. The Czech Republic*, where the Czech Republic had to pay US$ 269,814,000 in compensation. Just seeing these numbers (and knowing that it has been said that the amount is roughly comparable to the country's health budget for a year)[40], this kind of compensation does not seem *just.* I think there is a moral reason to change the system in favor of the host state. Most

[40] Crawford, 2010, p. 94.

countries spread the costs among their citizens: if the country has a public health care system, the costs of this health care system is spread among its citizens through taxes and other public fees. This holds for most domestic systems: public services are financed by taxation of their members. Some authors even go so far as to claim that by being forced to pay a huge award the country might not be able to guarantee that its citizens human rights are not violated.[41] If the compensation that the host state has to pay to the investor is so high that it is felt by its citizens, the system cannot be justified on utilitarian moral grounds.

The modification is done at the expense of the investors, these would after the modification has been introduced always be at a disadvantage compared to if the new rule would not apply. But in the long run, I think that this is a price the investors should be willing to pay if it can keep the investment treaty regime up and running. With Australia abandoning the investor-state arbitration clause and other countries questioning investment treaties altogether, more countries might feel compelled to stop signing investment treaties and not renew the ones they have already signed.[42] If one wants to uphold the investment treaty regime as an international standard, I believe the system needs to be changed in favor of the host states. It is after all states, and not investors, who sign the treaties. It is up to them to uphold or abandon the system.

4.2 Conclusion

Investment treaties have been credited for liberalizing the policies of countries that sign them. And depending on whether you oppose or encourage this process, this will influence your opinion about investment treaties. I oppose this process. Or rather, I do not believe that it is a process which only bring benefits. Investment treaties transfer some of the state powers unto investors. Investors, sometimes multinational cooperations like *Philip Morris Limited*, get rights and states get obligations. One could argue that states ought not to sign investment treaties at all, since they do not gain anything from signing. On this point though, I disagree. I believe that the host state and its citizens may gain from signing investment treaties and thus gaining investments, which hopefully generates jobs and income for both states and citizens alike. On this note, I do not oppose investment treaties. But on the other hand I do not think that states

[41] Chinen, 2014, p. 708.

[42] Trakman, 2012, p. 85.

today pay a reasonable price for this investment. I believe that as it stands today, investment treaties grant too much power to the investor and limits the host states actions too much. There should be an instrument which lets investors feel safer when investing in a foreign country, such as an investment treaty, but at the same time the host state should not feel that signing an investment treaty limits its actions when it concerns safeguarding certain interests which benefit the citizens or the environment. By lowering the amount of compensation in case of a treaty breach, some of the ”teeth” are removed from the system and it is now harder for investors to pose as a threat towards host states legislations. Host states are freer in their actions yet investors are not left without protection.

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