Perils of Success? The Case of International Investment Protection

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Topic: International Law and Economics

I. Introduction

Public International Law (PIL) sometimes suffers from ineffectiveness; a phenomenon either used to declare PIL epiphenomenal[1] or to construct rationally designed international institutions in order to make it more effective.[2] Traditionally, international lawyers only rarely ask questions of effectiveness,[3] and if they do, they usually assume that the more effective the law is, the better. But can PIL also become too successful? International Investment Law is one of the issue areas of PIL which has been very successful[4] over the past 15 years; we see a surge in the conclusion of Bilateral Investment Treaties (BITs)[5] in absolute terms - though a decline in relative terms since 1996 - as well as a surge of International Arbitration of Investment Disputes at around the same time.[6] From an international lawyer´s perspective this is a perfect development. But this may only be true on first sight.

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[1] So the realist tradition in PIL, lately also in the Law and Economics tradition Goldsmith, Jack L., and Eric A. Posner 2005. *The Limits of International Law*. Oxford: Oxford University Press.; for a review of the latter, see Aaken, Anne van. 2006a. To Do Away with International Law? Some Limits to 'The Limits of International Law'. *European Journal of International Law* 17 (1):289-308.

[2] E.g. Koremenos, Barbara, Charles Lipson, and Duncan Snidal. 2001. The Rational Design of International Institutions. *International Organization* 55 (4):761-799.

[3] Effectiveness and compliance are different but related notions. Determining whether a state complies with a treaty requires comparing the relevant state activity with the treaty's requirements. Effectiveness is directly related to, but distinct from, compliance and regards causality. A state may comply with a treaty, that is, its actions comport with the requirements of the treaty, but the treaty may nonetheless be ineffective in changing that state's practices. For these notions see Guzman, Andrew T. 2002. A Compliance-Based Theory of International Law. *California Law Review* 90 (6):1823-1887., for compliance theories Koh, Harold Hongju. 1997. Why do Nations Obey International Law? *Yale Law Journal* 106:2599-2659. and Helfer, Laurence R., and Anne-Marie Slaughter. 1997. Toward a Theory of Effective Supranational Adjudication. *Yale Law Journal* 107:273-391.

[4] By success I mean that the regime is used by relevant actors, i.e. States and foreign direct investors.

[5] From 1990 to 2004, there is a surge from less then 500 BITs to almost 2500 BITs, see UNCTAD. 2005. *World Investment Report*. New York/Geneva: United Nations., at 46. If investment chapters of regional trade agreements, such as NAFTA are included, there is even more treaty making activity in the investment protection area.

[6] UNCTAD 2005.

BITs may be interpreted as a mechanism for overcoming commitment problems between investor and host state in order not to infringe on the property rights of foreign direct investors, and ultimately to attract more investment. States thereby 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.[7] A problem one may identify lies in that over the last years, the costs of BITs for states have become ever larger, primarily due to progressive interpretation of international arbitral tribunals. Hence, a trade-off may be identified: on the one hand existing BITs are made more powerful in protecting investments by progressive interpretation of international arbitral tribunals (thereby mitigating the commitment problem); on the other hand this development might endanger the future of BITs and thereby the protection of foreign direct investment (FDI) due to high sovereignty costs; in the language of mechanism design: investment protection lawyers seem to overlook states' participation constraint. States can and already do react to this trade-off in various manners if they think that the pendulum has swung too far: They might keep out of the game altogether by not signing and ratifying BITs. They might also water down the substantive protection of foreign investors rights by renegotiating BITs or when concluding new BITs. They might restrict the interpretational supremacy of International Tribunals or they might just not comply with an unfavourable award of an international tribunal. They might also exit the game by not prolonging the treaties. It is hypothesized that over-protection of foreign investment may lead to reactions which in the long run will weaken investment protection; i.e. international investment law possibly has passed a threshold of protection for foreign direct investors which endangers the system on the whole and in the long run, thereby leading to ultimately undesired less protection of foreign direct investment.

The paper is organized as follows: first, a short overview on the functioning of international investment law is given. The second part will shortly look upon the success of International Investment Law and the empirical evidence of the impact of BITs on FDI. The third part will sketch the economic logic of BITs and the fourth part will, by making use of economic theory, deal with the perils of success. The last section will conclude by including some suggestions on how the perils may be mitigated.

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[7] Harten, Gus van, and Martin Loughlin. 2006. Investment Treaty Arbitration as a Species of Global Administrative Law. *European Journal of International Law* 17 (1):121-150. therefore draw an analogy to domestic administrative law rather than to international commercial arbitration, since investment arbitration engages disputes arising from the exercise of public authority by the state as opposed to private acts of the state. This analogy is also supported in Separate Opinion of Thomas Wälde in International Thunderbird Gaming Corporation v. Mexico, Decision of 26. January 2006 (NAFTA by UNCITRAL Rules), paras. 13, 27, 129 and 139.

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, i.e. a huge part of the international capital flow. Several attempts of drafting an international agreement failed up to date: most recently, the Draft Multilateral Agreement on Investment, negotiated under OECD auspices, failed spectacularly in 1998[8] and also the attempt to negotiate that topic under WTO auspices[9] failed for the time being, when the so called "Singapore issue" of investment was taken from the negotiating agenda of the Doha Round in summer 2004.[10] Thus, there are no encompassing multilateral legal rules for foreign direct investment. Nevertheless, the legal protection of foreign property has a long history[11] and there has been Customary International Law (CIL) protecting foreigners, including investors, by the so called "Minimum Standard of Treatment"[12] and compensation requirements for expropriations.[13] But this protection is, as already hinted at by the name,

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[8] In 1995, OECD Ministers launched negotiations on a multilateral agreement on investment (MAI) with high standards of liberalisation and investment protection, with effective dispute settlement procedures, and open to non-Members. Negotiations were discontinued in April 1998 and will not be resumed. For the negotiating history and reasons for failure, see Geiger, Rainer. 1998. Towards a Multilateral Agreement on Investment. *Cornell International Law Journal* 31:467-475.. For the text of the draft, see http://www.oecd.org/dataoecd/46/40/1895712.pdf.

9 Kentin, Esther. 2002. Prospects for Rules on Investment in the New WTO Round. *Legal Issues of Economic Integration* 29:61-71.

[10] Ministers from WTO member-countries decided at the 1996 Singapore Ministerial Conference to set up new working groups: on trade and investment, on competition policy, on transparency in government procurement as well as trade facilitation. These four subjects were originally included on the Doha Development Agenda. 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.

[11] For an overview see Lowenfeld, Andreas F. 2002. *International Economic Law*. Oxford: Oxford University Press., at 391-414.

[12] For a discussion of the Customary International Law character of protective norms in BITs, see Kishoiyian, Bernard. 1994. The Utility of Bilateral Investment Treaties in the Formulation of Customary International Law. *Northwestern Journal of International Law and Business* 14:327-375. and Al Faruque, Abdullah. 2004. Creating Customary International Law through Bilateral Investment Treaties: A Critical Appraisal. *Indian Journal of International Law* 44 (2):292-318., arguing against the formation of CIL through BITs, as well as Porterfield, Matthew C. 2006. An International Common Law of Investors Rights? *University of Pennsylvania Journal of International Economic Law* 27:79-113., 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 Hindelang, Steffen. 2004. Bilateral Investment Treaties, Custom and a Healthy Investment Climate - The Question of Whether BITs Influence Customary International Law Revisited. *Journal of World Investment and Trade* 5:789-809, Schwebel, Stephan. 2004. The Influence of Bilateral Investment Treaties on Customary International Law. *Proceedings of the American Society of International Law*:27-30.

[13] The so called „Hull-rule" which called for prompt, adequate and effective compensation in case of expropriation. This rule lost its customary law character due to several UN General Assembly Resolutions in the 1960ties and seventies; e.g. Art. 2 of Charter of Economic Rights and Duties of States (UN-GA Declaration 1974). Nevertheless, this kind of compensation requirement is now to be found in the BITs. See for details and an economic explanation for the on the first sight paradoxical behaviour of developing countries, Guzman,

only minimal and does not live up to the modern requirements of protection as the interference with property rights is much more refined nowadays – most contentious issues deal not with outright expropriation but rather regulatory expropriation or unfair treatment and disputes on contractual rights.

None the less, that does not mean that foreign investment is legally unprotected - on the contrary. Since the conclusion of the first BIT between Germany and Pakistan in 1959, foreign investment is governed ever more by BITs or by Regional Trade Agreements which include a chapter on investment protection, such as NAFTA.[14] BITs are an international law treaty giving protection to private persons or firms. Thus, the states give a reciprocal promise of treating the nationals of the other state in a certain manner.

Those BITs usually have quite similar substantive provisions.[15] They include the definition of the scope of application, i.e. a definition of what constitutes an investment and a definition of who counts as a foreign investor. The definition of investment tends to be asset based[16] and is thus very broad. Asset based definitions include all tangible and intangible assets and debt, contractual claims and intellectual property rights, including e.g. promissory notes or bank loans. This broad definition thus differs from the classical definition of FDI which usually requires a long term investment controlled by a foreigner who assumes a certain risk. The definition of "investor" is also broad. Whereas for natural persons the nationality requirement is usually uncontested, determining the nationality of a juridical person might be more difficult, as it can be defined by the place of incorporation, by seat or by control of the owners. BITs vary in their definitions and may use those requirements cumulative.[17] Rights of minority investors are usually included in the protection of the BITs, independent from the rights of the company itself.[18]

Andrew T. 1998. Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Treaties. *Virginia Journal of International Law* 38 (4):639-688.

[14] NAFTA, Chapter 11. Others are the Investment in Colonia Protocol of 1994 as annexed to the *Mercado Común del Sur* (MERCOSUR Agreement of 1991) and the Framework Agreement on the ASEAN Investment Area (1998, amended 2001). The paper will focus only on BITs but a similar reasoning applies to those Trade Agreements. The reasoning might not be exactly the same, as the trade agreements are linking issues and thereby generate different incentives and a different participation constraint.

[15] See UNCTAD Compilation. See for an overview on BITs Dolzer, Rudolf, and Margrete Stevens. 1995. *Bilateral Investment Treaties*. The Hague: Nijhoff.

[16] For an overview of the definitions, see UNCTAD. 2003. *UNCTAD Series on Issues in International Investment Agreements. Scope and Definition*. available at: http://www.unctad.org/Templates/webflyer.asp?docid=189&intItemID=1772&lang=1. On the notion of investment see also Rubins, Noah. 2004. The Notion of "Investment" in International Investment Arbitration. In *Arbitrating Foreign Investment Disputes*, edited by N. Horn. The Hague: Kluwer Law International.

[17] For an overview, see UNCTAD. 2004. International Investment Agreements: Key Issues Vol. I. *erhältlich unter: http://www.unctad.org/en/docs/iteiit200410_en.pdf*. on the term "investor".

[18] This is by now established case-law, see e.g. GAMI Investments, Inc. v. Mexico, Decision of 15. November 2004 (NAFTA by UNCITRAL Rules), at para. 26-42, where the investor had 14,18 % as well as CMS Gas Transition Company v. Republic of Argentina , Case No. ARB/01/8, Decision on Jurisdiction of 17. July 2003,

Furthermore, BITs contain general standards of treatment. They provide a protection against direct and indirect (also "creeping", "tantamount to") expropriation,[19] require fair and equitable treatment[20] of the investor, provide for national treatment and usually contain a most favoured nation clause (MFN). They also might contain a so-called "umbrella clause", which is a general promise to honour the obligations the states entered into with the foreign investor, usually some contractual agreements, such as licences or concession agreements.[21] The latter clause may elevate contractual claims to international law claims; it is therefore quite contested. Few BITs include a security interest-"Escape Clause" for states.[22]

Last, but not least, almost all treaties provide for international dispute settlement by which states waive their immunity from suit. The usual international forum selected is the

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42 ILM 788 (2003), available at: http://www.asil.org/ilib/cms-argentina.pdf. See for an overview Alexandrov, Stanimir A. 2005. The "Baby Boom" of Treaty-Based Arbitrations and the Jurisdiction of ICSID Tribunals: Shareholders as "Investors" and Jurisdiction Ratione Temporis. *The Law and Practice of International Courts and Tribunals* 4 (1):19-59.

[19] For the notion, see Kunoy, Bjorn. 2005. Developments in Indirect Expropriation Case Law in ICSID Transnational Arbitration. *Journal of World Investment and Trade* 6 (467-491). and OECD. 2004. "Indirect Expropriation" and the "Right to Regulate" in International Investment Law. *Working Papers in International Investment Number 2004/4*., Been, Vicki, and Joel C. Beauvais. 2003. The Global Fifth Amendment? NAFTA´s Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine. *New York University Law Review* 78:30-143, Brunetti, Mauricio. 2003. Indirect Expropriation in International Law. *International Law RORUM du droit International* 5:150-154, Dolzer, Rudolf. 2002. Indirect Expropriations: New Developments? *New York University Environmental Law Journal* 11:64-93, Dolzer, Rudolf, and Felix Bloch. 2003. Indirect Expropriation: Conceptual Realignments? *International Law RORUM du droit International* 5:155-165, Fortier, L. Yves, and Stephen L. Drymer. 2004. Indirect Expropriation in the Law of International Investment: I know It When I See It, or Caveat Investor. *ICSID Review - Foreign Investment Law Journal* 19 (2):293-327, Newcombe, Andrew Paul. 2005. The Boundaries of Regulatory Expropriation in International Law. *ICSID Review-Foreign Investment Law Journal* 20 (1):Available at SSRN: http://ssrn.com/abstract=789706.

[20] See Schreuer, Christoph. 2005. Fair and Equitable Treatment in Arbitral Practice. *Journal of World Investment and Trade* 6 (3):357-386., Choudhury, Barnali. 2005. Evolution or Devolution? Defining Fair and Equitable Treatment in International Investment Law. *Journal of World Investment and Trade* 6 (2):297-320, Dolzer, Rudolf. 2005. Fair and Equitable Treatment: A Key Standard in Investment Treaties. *International Lawyer* 39:87-106, Schill, Stephan. 2006. Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law. *ILJ Working Paper 2006/6 (Global Administrative Law Series), available at http://www.iilj.org/20066SchillGAL.htm,* Vasciannie, Stephen. 2000. The Fair and Equitable Treatment Standard in International Investment Law and Practice. *The British Yearbook of International Law* 70:99-164, Yannaca-Small, Catharine. 2004. Fair and Equitable Treatment Standard in International Investment Law. *OECD Working Papers in International Investment Number 2004/3; available at http://www.oecd.org/dataoecd/22/53/33776498.pdf*.

[21] See Alexandrov, Stanimir A. 2004. Breaches of Contract and Breaches of Treaty-The Jurisdiction of Treaty-Based Arbitration Tribunals to Decide Breach of Contract Claims in SGS v Pakistan and SGS v Philippines. *Journal of World Investment and Trade* 5:555-578, Kunoy, Bjorn. 2006. Singing in the Rain: Developments in the Interpretation of Umbrella Clauses. *Journal of World Investment and Trade* 7 (2):275-300, Schreuer, Christoph. 2004. Travelling the BIT Route - Of Waiting Period, Umbrella Clauses and Forks in the Road. *Journal of World Investment and Trade* 5:231-256, Sinclair, Anthony C. 2004. The Origins of the Umbrella Clause in the International Law of Investment Protection. *Arbitration International* 20 (4):411-434, Wälde, Thomas. 2005. The "Umbrella" Clause in Investment Arbitration: A Comment on Original Intentions and Recent Cases. *Journal of World Investment and Trade* 6:183-236.

[22] E.g. some of the US BITs: "This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, 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."

International Centre for Settlement of Investment Disputes (ICSID) arbitration,[23] or international arbitration by UNCITRAL rules. The ICSID Convention was created in 1965 under World Bank auspices with the goal of fostering private capital flow to developing countries. It is in many aspects a very effective institution and even though it started of late to be used, in the last fifteen years its success has become amazing. Known investment treaty arbitrations surged from almost zero to almost 250 by 2005, most of the cases being conducted under ICSID.[24] Whereas the conclusion of BITs had its peak in the middle of the nineties and is since then relatively declining, the disputes arising out of those BITs are on a continuous surge. Many of the indeterminate legal terms to be found in the BITs have only recently become more clarified by the decisions of ICSID tribunals and many of the interpretations are highly disputed, e.g. the jurisdictional question on who is an investor where not only the question of nationality but also the question of minority shareholders arise; the meaning of "Fair and Equitable Treatment" and indirect expropriation as well as the "Umbrella-Clause"; that is, under what circumstances does a breach of contract amount to a breach of PIL with the consequence of international jurisdiction, the scope of the MFN clause and its possibility for forum shopping.

Whereas there is no uniform text of international investment protection and no sitting judicial body, as the Appellate Body in WTO law, there is nevertheless a corpus of fairly similar substantive provisions and an international arbitration mechanism for investment (ICSID), even though the composition of the tribunals vary from case to case and also their interpretations (of similar and even equal clauses) may vary. The system is unique for PIL in that it allows private persons to bring an action against a state, often even without the exhaustion of local remedies requirement. International Investment law acquires immense force by this provision as private (juridical) persons are much more likely to take up their own case. Under the former system, governments had discretion whether they wanted to grant diplomatic protection to their nationals (as is the case under WTO). That weakened investors´ protection as states follow of course their own (diplomatic and political) calculus and might have well considered reasons why they do not take a case to an international court or tribunal even if their own nationals are concerned.

[23] For an extensive study, see Reed, Lucy, Jan Paulsson, and Nigel Blackaby. 2004. *Guide to ICSID Arbitration*. The Hague: Kluwer.

[24] See UNCTAD 2005. The ICISD websites registers 104 concluded cases (not all of them concluded by arbitration) and 103 pending cases as of 14 April 2006, see http://www.worldbank.org/icsid/cases/cases.htm.

III. The Success of International Investment Law

The success of International Investment Law in the past 15 years has been phenomenal.[25] Not only have we seen a proliferation of BITs but the system is also used by the relevant actors, i.e. the states and the investors which make ever more use of international arbitration by relying on the provisions of the BITs. Even though there are around 2400 BITs by now, if a similar effect to that of WTO covering investments would be desired, one would need 11.175 BITs (calculating with the 150 WTO member states) in order to have a worldwide protection of investment, similar to the inclusiveness of WTO. Whereas the first BITs were concluded between developed and developing countries, there are ever more BITs (and Free Trade Agreements) between developing countries. Nevertheless, one can note a relative decline in the conclusion of BITs, with a peak in the middle of the nineties. This relative decline occurs simultaneously with the surge of international arbitration based on BITs. The decline seems not to be attributable to saturation as investment flows are not confined to a few countries only. If BITs are to be seen as a potential marketing instrument by states, this marketing should reach all possible investors (and therefore countries).

But that is of course only one way to look at the success. The other one is the question of whether BITs do really foster foreign direct investment. If they would not, there would be no reason for states to trade off (regulatory) sovereignty against credibility and investment. The empirical evidence has been inconclusive though tilts now slightly toward finding positive relationship between BITs and FDI. Whereas Hallward-Driemeier finds no significant effect of BITs on FDI[26], Tobin and Rose-Ackerman find that the relationship between FDI and BITs is weak with a slightly more positive effect at high levels of country risk[27] and in a newer study confirm a positive relationsship.[28] Salacuse and Sullivan find that stricter BITs increase FDI whereas less strict BITs have no significant effect. They compare US BITs with BITs from other OECD countries, which are indeed less strict for a variety of reasons, e.g.

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[25] Similar Elkins, Zachary, Andrew Guzman, and Beth Simmons. 2004. Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000. *UC Berkeley Public Law Research Paper No. 578961 : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=578961.*

[26] Hallward-Driemeier, Mary. 2003. Do Bilateral Investment Treaties Attract FDI?: Only a bit... and they Could Bite. *World Bank Policy Research Working Paper No. WPS 312, available at http://wdsbeta.worldbank.org/external/default/WDSContentServer/IW3P/IB/2003/09/23/000094946_03091104060047/Rendered/PDF/multi0page.pdf.*

[27] Tobin, Jennifer, and Susan Rose-Ackerman. 2005. Foreign Direct Investment and the Business Environment in Developing Countries: the Impact of Bilateral Investment Treaties.Yale Law & Economics Research Paper No. 293, available at SSRN: http://ssrn.com/abstract=557121.

[28] Tobin, Jennifer, and Susan Rose-Ackerman. 2006. When BITs Have Some Bite: The Political-Economic Environment for Bilateral Investment Treaties. *available at : http://www.law.yale.edu/documents/pdf/When_BITs_Have_Some_Bite.doc.*

admission of investment as well as the prohibition of performance requirements.[29] The newest and most extensive and reliable study was done by Neumayer and Spees. They find an overall positive and significant effect of BITs on FDI.[30] In short: BITs matter and do what they are supposed to do, namely fostering foreign direct investment, all other things being equal. That of course does not mean that other factors such as market size, market potential and natural resources may not be more important as a decision factor for enterprises.

IV. The Economic Logic of BITs

Undisputedly, countries, especially developing countries, have a strong incentive to attract FDI and they are competing for it.[31] The fundamental problem for countries which do not have a strong property rights protection in national law is to make the protection more credible. Customary International Law protection, as alluded to above, is insufficient in its substantive provisions and even less clear in its contours than the indeterminate legal terms found in the BITs.[32] One should note, though, that if Customary International Law can be established for substantive provisions, it can much more forceful than treaty law[33] – as long as there is international jurisdiction on the case - because Customary International Law does not give an opt out option in the long run as treaties do.[34] Every state is bound by Customary International Law, unless it is a persistent objector. Thus, the participation constraint of states is weakened.

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[29] Salacuse, Jeswald W., and Nicholas P. Sullivan. 2005. Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and their Grand Bargain. *Harvard International Law Journal* 46:67-129.

[30] Neumayer, Eric, and Laura Spees. 2005. Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries? *World Development* 33 (10):1567-1585.. They have data from 119 countries and look at the period from 1970 to 2001. Büthe, Tim, and Helen V. Milner. 2005. The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through Policy Commitment Via Trade Agreements and Investment Treaties? *Working Paper, available at: http://polisci.ucsd.edu/calendar/ButheMilner_FDI_24mar05.pdf*. also find a positive relationship.

[31] Elkins, Zachary, Andrew Guzman, and Beth Simmons. 2004. Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000. *UC Berkeley Public Law Research Paper No. 578961 : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=578961*. and Guzman, Andrew T. 1998. Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Treaties. *Virginia Journal of International Law* 38 (4):639-688.

[32] For a difference of incentives between Customary International Law and Treaty Law, see Norman, George, and Joel P. Trachtman. 2005. The Customary International Law Game. *American Journal of International Law* 99:541-580. as a response to Goldsmith, Jack L., and Eric A. Posner. 1999. A Theory of Customary International Law. *University of Chicago Law Review* 66:1113-1177.. See also supra note 12.

[33] The new US Model BIT 2004 therefore states clearly in Annex A what is to be understood by Customary International Law.

[34] For an overview on the definition and different understandings of Customary International Law, see Bernhardt, Rudolf. 1992. Customary International Law. In *Encyclopedia of Public International Law*, edited by R. Bernhardt: Elsevier., at 902 et seq. and Roberts, Anthea Elizabeth. 2001. Traditional and Modern Approaches to Customary International Law. *American Journal of International Law* 95 (4):757-791.; for a game theoretical treatment, see Norman, George, and Joel P. Trachtman. 2005. The Customary International Law Game. *American Journal of International Law* 99:541-580.

The problem of the host state is then to make its commitment more credible. As ex ante the potential host state can promises to honour the property right of investor, ex post, the state may renege on its promises, if there is no sanction. Firms can usually not disinvest in full once they have placed a fix investment. States can take advantage of that in several ways, e.g. by increasing taxes (even though they might have promised a preferential tax regime for the investor), by changing the royalty division in case of natural resources extraction,[35] or by prohibiting the augmentation of prices in cases of privatized utilities.[36] The host state will do so if the net benefit of reneging on its promise is greater than the net benefit of complying with its promise. As firms anticipate a possible later expropriation or unfair treatment, they may refrain from investment - and socially undesired less investment would be the result.

The solution to the problem is to make commitment of the host state credible - and BITs do exactly that. Investment protection thus becomes an instrument to attract scarce resources by reducing the risk of ex post opportunism of host countries. BITs bring host states under a credible threat, should it renege on its international law promises (that is the BIT) or on its promise in a national law state contract (e.g. concession agreements) if there is an umbrella clause. The commitment is made especially credible by third party adjudication, that is, ICSID or UNCITRAL arbitration mechanisms. These international dispute settlement fora allow for a circumvention of national courts which may either be dependent on government and/or might show a home bias or have too long adjudication periods. Furthermore, by giving *ius standi* to take dispute to international tribunal to investors directly, without the need to beg their home governments to take up diplomatic protection, the system relies on a very effective threat mechanism, especially so because investors may go to international arbitration often without exhaustion of local remedies.[37] By creating that system, the pay-off for the host states is changed through sanctions. Direct sanctions consist in the damages to be paid which may be quite high for developing countries.[38] The ICSID decisions have *res iudicata* effect[39] in all 143 Member States of the Convention which means that the decisions can be executed if the

[35] This is currently a huge problem for foreign oil companies in Venezuela.

[36] E.g. Aguas del Tunari v. Bolivia, 21.10.2005 – ICSID Case No. Arb/02/3 (Water Utility), available at: http://www.iisd.org/pdf/2005/AdT_Decision-en.pdf and CMS Gas Transmission Company v. Argentine Republic, 12.05.2005 – ICSID Case No. Arb/01/8, available at: http://ita.law.uvic.ca/documents/CMS_FinalAward_000.pdf (Energy Transport Utility).

[37] Most BITs have some kind of waiting period for negotiation and do require a very short period of time in which national courts need to decide (e.g. 3 or 6 month), which makes the latter requirement de facto inapplicable as court procedures usually take much longer than that, even in developed countries.

[38] Even though Argentina is an extreme case, it can expect over 20 billion US-dollars in damages from around 35 pending cases, amounting to an annual budget for compensation for the emergency measures it has taken in its economic crisis 2000/2001.

[39] The Member States recognize ICSID awards as national court decisions; that is the awards have the formal imprimatur that award is binding and final, Art. 53 (1) ICSID Convention.

host state has property in those countries (e.g. bank accounts) unless sovereign immunity comes into play. This makes a renegation on the decision of an ICSID tribunal much more difficult than non-compliance with e.g. the New York Convention,[40] where national courts can review the international arbitral award and set it aside, e.g. for public policy reasons. ICSID arbitration therefore is a much securer dispute resolution mechanism than other venues.

Quite as forceful are the indirect sanctions of reputational effects of being an unreliable state.[41] The reputational effect can come into play not only with an award against the host state and/or the non-compliance with an award but already at an earlier stage, that is, when a case is published as pending on the ICSID website. Already at that stage the host state may lose its reputation. A bad (or good) reputation may be reversed by a new government which may take measures in order to seem more credible and in order to attract investment (or reverse the investment policy as Bolivia has done).

V. The Perils of Success

On the first sight, economic logic tells us that BITs are an adequate mechanism for the commitment problem. Nonetheless, we face an optimization problem which I wish to outline here. More generally speaking, commitment problems in PIL are best solved by "Hard Law".[42] Abbott and Snidal identify three variables in order to determine the "hardness" of an agreement: (1) Obligation (O): how binding is the obligation?; (2) Precision (P): how precise is the obligation? and (3) Delegation (D): is there any central authority created for monitoring and adjudication?. International Law is to be found on a continuum on a scale from "soft" to "hard law". International Investment Law belongs rather to the corner of "hard law", thereby creating credible commitments, except for the precision of the terms of the BITs. BITs can be characterized as incomplete contracts due to transaction costs and bounded rationality.[43] Therefore, a problem arises due to the discretion in interpreting BITs by international tribunals. This is aggravated because most BITs have been concluded before the surge in

[40] Convention on the Recognition and Enforcement of Foreign Arbitral Awards (= NY Convention) from 1958 which presumes the validity of awards and mandates enforcement except for procedural grounds or public policy grounds.

[41] See for an economic theory of compliance based on reputational effects Guzman, Andrew T. 2002. A Compliance-Based Theory of International Law. *California Law Review* 90 (6):1823-1887.

[42] Abbott, Kenneth W. , and Duncan Snidal. 2000. Hard and Soft Law in International Governance. *International Organization* 54 (3):421-456.

[43] Williamson, Oliver E. 1985. *The Economic Institutions of Capitalism*. New York: Free Press.. See also Brousseau, Eric, and Jean-Michel Glachant. 2002. The Economics of Contracts and the Renewal of Economics. In *The Economics of Contracts*, edited by E. Brousseau and J.-M. Glachant. Cambridge: Cambridge University Press. for an overview on the theory of contracts in economics.

arbritral decisions. It was thus difficult for states to predict judicial outcomes of disputes with any degree of certainty. This in turn gives rise to two connected perils.

The first peril arises in cases where investors may also play opportunistically, e.g. in cases of forum shopping possibilities (MFN and the nationality of investors). From the viewpoint of foreign investors it is for each individual firm rational to play the BIT-Game opportunistically and try to go to ICSID in order to get progressive interpretation of the BIT. For the group of investors though, that may result in less "hard law" promises made by states, leading to less protection for firms. Investors therefore find themselves in a classical prisoners´ dilemma game.

One possible consequence for states is the costs of (unforeseen) strict promises. Therefore, a second, closely connected, peril arises: the participation constraint of states. Generally speaking, states will only participate in the system if the expected benefit of constraining its (regulatory) sovereignty through BITs and state contracts will deliver expected net benefits. States may not like "hard law" due to sovereignty costs, i.e. costs which are created by the restriction of possible action, e.g. certain regulatory measures may not be taken or certain policies may not be allowed without due compensation (e.g. environmental measures, tax policy, or certain economic or monetary policy). The obligation is therefore high, if the *ex ante explicit* restriction of reaction possibilities to unforeseen circumstances is high. Often, e.g. there are usually no escape clauses in BITs as in the WTO (e.g. Art. XX GATT or the Safeguards Agreement), though sometimes an escape of the BIT obligations is possible by taking measures for "protection of its own essential security interests"[44] Here, the force of the obligation depends much on whether these escape clauses are self-judging. This is usually denied by international tribunals unless the clauses explicitly say so, even against the will of both State Parties to the relevant BIT.[45] The costs of the obligations may thus be quite high as

[44] E.g. Art. XI US-Argentine BIT.

[45] The tribunal in CMS Gas Transmission Company v. Argentine Republic, 12. 5. 2005 – ICSID Case No. Arb/01/8, available at: http://ita.law.uvic.ca/documents/CMS_FinalAward_000.pdf, rejected this provision 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 (contrary to the national emergency law of Argentina). It also held, contrary to the expert opinion of Prof. Slaughter that it 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 controlled 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 Sept. 2005, at para. 39, available at: http://ita.law.uvic.ca/documents/cmsannulmentapplication.pdf that the State Department of the United States viewed such clauses as self judging. Thus, though both states involved argued for self-judgement, the tribunal did not agree. A similar reasoning was applied by the tribunal in LG&E v. Argentina, Decision on Liability of Oct. 3, 2006 – ICSID Case No. ARB/02/1, the Tribunal also supports that the escape clause was not self-judging and stated that the U,S, at the time of concluding the Argentina BIT still supported that these clauses were not self-judging and only later changed its position.

a country may not be free anymore to react to external or internal economic or political shocks and crises without paying compensation to foreign investors.[46]

Furthermore, states may not want to ratify BITs which restrict their sovereignty *unpredictably.* There is an informational problem for states as in t_1 host countries give promises which will lead to welfare losses in the future. Here, flexibility costs, a subset of sovereignty costs, arise, i.e. states may not act as they thought ex ante they could. Generally speaking, if Precision P is high, then also the flexibility costs, understood as sovereignty costs may be high. Therefore, states may prefer low precision ex ante, unless they feel that they can explicitly restrain certain protective norms without loss of credibility.[47]

If precision is low, then the flexibility costs depend crucially on the interpretation by the tribunal. In practice, we find quite progressive interpretation by ICSID Tribunals.[48] In the view of some tribunals, BITs are instruments for the maximization of investor protection; accordingly, uncertainties as to how to resolve ambiguous treaty provisions should be resolved in favour of foreign investors.[49] Lately, few other 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".[50] The United States, in a dispute concerning itself as respondent

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[46] Here, much depends also on a possible state contract. If there is an agreement for a certain tax treatment, the state may not be free to raise taxes for the foreign investor (though of course for national investors). On the connection between state necessity under Customary International Law (state responsibility) and investment protection, see Aaken, Anne van. 2006b. Zwischen Scylla und Charybdis: Völkerrechtlicher Staatsnotstand und Internationaler Investitionsschutz. *Zeitschrift für vergleichende Rechtswissenschaft* 105:544-569.

[47] 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." This is, of course, a reaction to extensive interpretation of ICSID tribunals. The same holds for the investment part of the Japan-Philippines Economic Partnership Agreement, available at: http://www.mofa.go.jp/region/asia-paci/philippine/epa0609/main.pdf, which states several exceptions and safeguards concerning reagulatory issues (see Arts. 99 et seqq.)

[48] Buergenthal, Thomas. 2006. The Proliferation of Disputes, Dispute Settlement Procedures and Respect for the Rule of Law. *Transnational Dispute Settlement; Online Journal*., at 7 et seq. warns of the conflict of interest arising out of arbitrators who are simultaneously employed as counsels to firms involved in investment disputes. He diagnoses a manus manum lavat problem in connection with a revolving door problem. This, in his opinion, might be a danger for the rule of law.

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

[50] Pan American Energy LLC and BP Argentina Exploration Company v. Argentine Republic, ICSID Case No. ARB/03/13 and BP America Production Co. and Others v. Argentine Republic, ICSID Case No. ARB/04/8, at para. 99 and El Paso Energy International Company v. Argentine Republic (ICSID Case No. ARB/03/15), Decision on Juriscistion, at paras. 66 et seqq, 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 favour of foreign investors or in favour of host states. See also *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award of 12 October 2005, para. 52 (concerning

contended 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 and private persons, such ambiguity is always to be resolved in favour of maintaining state sovereignty".[51]

Indeterminate legal terms, as e.g. "fair and equitable treatment" are often interpreted investor friendly, i.e. foreign investors are often treated more favourably than national investors, e.g. in environmental regulation matters[52] or in economic emergency cases. As mentioned above, the invocation of state necessity in the BIT and in Customary International Law[53] by Argentina due to its economic crisis in 2000/2001 was not followed by the tribunal, thereby obligating Argentina to pay compensation for the tariff freeze of public utilities and its devaluation of its currency as this was seen to be an infringement of "fair and equitable treatment".[54] National investors did not get any compensation as their way to ICSID is barred.

Furthermore, the definition of investor in the BITs has been a contentious issue as here the definition of investors decides on who can get the protection of a BIT and to whom the promise of the state was made. It might happen that the state faces an unexpected extension of the circle of promisees. In Tokios Tokeles v. Ukraine[55], a dispute mounted under the Lithuania-Ukraine BIT, where a group of Ukrainian investors had incorporated a legal entity in Lithuania, and then used that entity to invest back into Ukraine - and thereby avail themselves of the protections promised to "Lithuanian" investors by Ukraine under the BIT. The majority of the Tribunal stated that the parties to a BIT were free to determine the criteria to determine nationality[56] and set the definition of investor and foreign control of a local entity for purposes of Art. 25 (2)(b) of the ICSID Convention. In a rare occurrence, the President of an ICSID arbitral tribunal, Prosper Weil, has dissented from this decision on jurisdiction and has signalled 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

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the teleological interpretation of an umbrella clause: "The object and purpose rule also supports such an interpretation. While it is not permissible, as is too often done regarding BITs, to interpret clauses exclusively in favour of investors, here such an interpretation is justified.")

[51] Methanex Corp. v. United States of America, UNCITRAL, 1st Partial Award (August 7, 2002), at para. 103, available at: http://www.state.gov/s/l/c5818.htm.

[52] See for a discussion Dolzer, Rudolf. 2002. Indirect Expropriations: New Developments? *New York University Environmental Law Journal* 11:64-93.

[53] As codified in Art. 25 ILC Draft on State Responsibility.

[54] For a discussion of the case in the broader context of state necessity and investment protection, see Aaken, Anne van. 2006b. Zwischen Scylla und Charybdis: Völkerrechtlicher Staatsnotstand und Internationaler Investitionsschutz. *Zeitschrift für vergleichende Rechtswissenschaft* 105:544-569.

[55] Decision of April 29, 2004, Case No. Arb/02/18, available at: http://www.worldbank.org/icsid/.

56 Id at paragraph 24.

and go against international law principles. In Aguas del Tunari v. Boliva, the investors migrated the holding of Aguas del Tunari from the Bahamas to Luxembourg, whose shares were in turn held by a newly set up firm in the Netherlands, thereby using the Netherlands-Bolivian BIT in order to go to ICSID.[57] The definition of the nationality of corporate entities is a long known problem, but becomes ever more pressing in a more globalized world where firms are every more complicatedly structured. It is unclear whether tribunals accept or pierce the corporate veil. When they choose the latter, it is also unclear whether they stop at the first level shareholders or whether they look at the ultimate beneficiaries or stop somewhere in between.[58] The possibility of BIT-shopping by enterprises is therefore a problem from the viewpoint of states.

A further unforeseen circumstance is the interpretation of the most favoured nation (MFN) clause, a multilateralization devise par excellence which allows investors to get the protection of any other BIT concluded by the host state in case it is more favourable than the BIT between the host state and his home state. Whereas MFN clauses were supposed to apply only to substantive issues, in Maffezzini v. Spain,[59] the ICSID tribunal decided that the MFN clause applies also to procedural provisions.[60]

A further contentious issue is the so called "umbrella clause". The interpretation debate over the concrete meaning of this - potentially powerful - provision found in many BITs has high stakes as it decides on the applicable law as well as the forum of the dispute (national vs. international). On an extensive reading, such clauses open up the possibility to sue states under international law whenever a contractual commitment or undertaking has been breached by a state or state agency – without it being necessary to prove some other breach of the relevant treaty. In that interpretation, the clause subsumes all contractual breaches under the umbrella of the treaty, thus obviating the need for foreign investors to rely on the dispute settlement provisions contained in the relevant state contract (for e.g. local courts or other

[57] The ultimate majority owner was Bechtel, a US-American firm.

[58] See Acconci, Pia. 2004. Determining the Internationally Relevant Link between a State and a Corporate Investor. *Journal of World Investment and Trade* 5:139-175, Wisner, Robert, and Nick Gallus. 2004. Nationality Requirements in Investor-State Arbitration. *Journal of World Investment and Trade* 5:927-945.

[59] Case No. Arb/97/7.

[60] The Maffezzini reasoning was recently followed by Suez, Sociedad General de Aguas de Barcelona S.A., and InterAguas Servicios Integrales del Agua S.A. v. Argentina (ICSID Case No. ARB/03/17), Decision on Jurisdiction (May 16, 2006), at para. 52 et seq. It distinguished its reading from Plama Consortium Limited (Claimant) and Republic of Bulgaria (ICSID Case No. ARB/03/24), Decision on Jurisdiction (February 8, 2005). In a recently decided case though (Sept. 13, 2006), Telenor Mobile Communications AS v. Republic of Hungary (Case No. ARB/04/15), the Tribunal declined the protection of the MFN clause to procedural issues, noting that "In these circumstances, to invoke the MFN clause to embrace the method of dispute resolution is to subvert the intention of the parties to the basic treaty, who have made it clear that this is not what they wish", see Investment Treaty News (ITN), September 20, 2006. In the same vein *Berschader v. Russia* (this case was also recently reported in ITN, August, 23, 2006).

forms of arbitration).[61] Nevertheless, tribunals have openly clashed over the meaning to be ascribed to such treaty clauses, and the extent to which they may permit foreign investors to dispense with the dispute settlement provisions spelled out in contracts in favour of pursuing international arbitration under a treaty.[62]

The list could be continued but may suffice for getting the picture: The problem arising through progressive interpretation[63] is that states thought of giving a promise P_A in t_1 and find out in t_2 that they promised P_B (with $P_B > P_A$). By a learning process, it is to be expected that in the light of the experiences with too favourable or unforeseen promises, countries will turn to less favourable promises or restrict the interpretational discretion of international tribunals, if they think that the net benefit of credible commitment is turning negative. They might change the promise P_A for the future by various means:

They may just not enter the system by declining to ratify BITs; indeed we do see a relative decline in conclusion of BITs. The United States and Southern African Customs Union (SACU), .e.g. were negotiating a Free Trade Agreement but broke the talks off as SACU did not want to include a US proposal on investment liberalization and protection provisions in the proposed free trade agreement.[64] Ecuador has been the first country to publicly announce that it may withdraw from its BITs.[65]

They may also restrict in the new BITs the interpretational supremacy of International Tribunals by including a general saving for interpretation. Some BITs and RTA do contain provisions which retain the last competence for interpretation for the states, e.g. NAFTA.[66] The NAFTA Free Trade Commission issued a binding statement in 2001 concerning the interpretation of Fair and Equitable Treatment.[67] It held that this provision equals only Minimum Standard of Treatment and does not contain any transparency requirements for

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[61] See Investment Treaty News June 15, 2006.

[62] Very instructive on that is the EL Paso ruling, supra note 50.

[63] Whether some of the interpretations are even praeter legem interpretations may be discussed.

[64] Investment Treaty News, April, 27 2006, published by the International Institute for Sustainable Development (http://www.iisd.org/investment/itn).

[65] Franck, Susan D. 2005. Occidental Exploration & Production Co. v. Republic of Ecuador. *American Journal of International Law* 99:675-681.

[66] Under WTO law the same holds: Art. IX (2) WTO Agreement reserves the ultimate interpretational authority to a three-fourth majority of member states.

[67] See "Free Trade Commission Clarifications Related to NAFTA Chapter 11," July 31, 2001, at http://www.ustr.gov/regions/whemisphere/nafta-chapter11.html. 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. Art. 91 Japan-Philippines Economic Partnership Agreement, available at: http://www.mofa.go.jp/region/asia-paci/philippine/epa0609/main.pdf, now repeats the NAFTAs Free Trade Commissions remarks with regards to the relationship between "fair and equitable treatment" and the international minimum standard, just as the new US Model BIT of 2004 does.

states, thereby cutting back on the progressive interpretation of ICSID tribunals (to which most of NAFTA cases go). Very few BITs or RTAs retain this binding interpretational competence to States[68] which means that this ultimate restriction for international tribunals does not work everywhere.[69] Furthermore, of course, all State Parties to the treaty have to agree on a common interpretation of a treaty norm. But nevertheless, that is a less costly, though more subtle, way than treaty renegotiation.

They may also restrict progressive interpretation by further specification on the interpretation of the protective norms in the next round of BIT negotiations (as the US has done in its new Model BIT 2004). Here, states write more complete contracts in clarifying indeterminate legal terms, e.g. by stating that certain environmental or public security measures do not amount to indirect expropriation.[70] States may also water down the protection of investors by attenuating their rights from the beginning. The Economic Cooperation Agreement between India and Singapore of 2005, e.g. left out the highly contentious provisions of Fair and Equitable Treatment and the MFN Clause. That, of course, means much less protection as usual in BITs. The newly negotiated Trade and Investment Pact between Japan and the Philippines has all usual substantive protective provisions but leaves out and investor-state arbitration mechanism which the states consent ex ante.[71]

States may also choose non-compliance, even though that may be more costly for reputational reasons. Here, a state will calculate whether compliance is more costly that losing foreign investment in the short run. Argentina, e.g., already announced that it will not honour the ICSID rewards in connection with the Argentine Crisis of 2000/2001,[72] though that statement was revoked in the decision on the staying of the award.[73] There are several (legal) ways for not being obliged to accept the execution of an ICSID award.[74]

Last, but not least, states may decide to exit the treaties by not prolonging them. Most BITs are concluded for a certain period of time (e.g. 30 years with extension of the protection for another period of time, e.g. 10 years) but may be prolonged.

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[68] Whereas the US model BIT does, the Swiss Model BIT, and more generally the European BITs do not.

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

[70] See e.g. the new US Model BIT 2004 which contains rules of interpretations for the tribunals concerning the most contentious terms.

[71] See Art. 107 Japan-Philippines Economic Partnership Agreement, available at: http://www.mofa.go.jp/region/asia-paci/philippine/epa0609/main.pdf.

[72] See Marzorati, Osvaldo J. 2005. Argentina Opting Out? *Transnational Dispute Settlement* 2 (3)..

[73] Decision on Argentine Republic's Request for a Continued Stay of Enforcement of the Award, 1 September 2006.

[74] Baldwin, Edward, Mark Kantor, and Michael Nolan. 2006. Limits to Enforcement of ICSID Awards. *Journal of International Arbitration* 23 (1):1-24.

Those arguments do not only apply to developing countries. Ever more, the capital flows from transition or developing countries such as China and India to the OECD countries (or other developing countries). It seems that only the USA has gone through a learning process by NAFTA, being the defendant state in some cases and changing its new Model BIT in 2004 accordingly by making it more precise, giving less leeway to arbitral tribunals.[75] Western European states until now were spared being a defendant in investor to 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. It might well be that then those countries might also become more cautious in negotiating too sovereignty restricting BITs 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 progressive protection ex post may lead to reactions of states which will weaken international investment protection in the long run – a normatively not desirable outcome.

VI. Conclusion and Outlook

One example of effective PIL is the case of international investment protection. But this effectiveness comes with perils, namely that states would wish to weaken the system in order not to incur too high sovereignty costs. We therefore face a dilemma: International Investment Law may be made too successful from the viewpoint of states which may lead to less protection of investors in the long run. The point of optimality between cost of commitment and benefit of FDI still needs to be found. This resembles a problem well known in contract theory, namely inefficient collaterals. Economic modelling accordingly is in progress.

States´ participation constraint comes into play only if the net benefit of giving credible commitments to investors equals or is below zero. And 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. There might be circumstances in which we come close to situations where states prefer to opt out, e.g. certain Latin American countries, which – within the Calvo doctrine tradition - would return to an old attitude towards FDI. Therefore, it is useful to think of other less costly instruments for states

[75] Gagné, Gilbert, and Jean-Frédéric Morin. 2006. The Evolving American Policy on Investment Protection: Evidence from Recent FTAs and the 2004 Model BIT. *Journal of International Economic Law* 9:357-382., attribute e.g. the dropping of an investor to state dispute mechanism in the Australian-US FTA to the US experience of complaints by Canadian investors under NAFTA, that is investors from an equally developed country.

of protection, e.g. insurance regimes which reduce sovereignty costs. It is also useful to consider BITs which either retain the interpretational supremacy of the State Parties or which are drafted in more detail. This also need to be considered once the BITs are renegotiated. It would also be desirable to have a more balanced approach to treaty interpretation. Even if BITs and ICSID are designed to foster FDI by protection, the ultimate *telos* of those laws is the development of countries.[76] This is also clearly indicated by the ICSID Convention which could not have been negotiated under World Bank auspices otherwise. Though under most BITs states retain the right to admit foreign investment and they themselves are probably best positioned to judge whether a specific investment is beneficial to their development, this does not solve the problem of a too sweeping unforeseen protection ex post. Of course, the question of quis iudicabit is to the fore of those problems. A more balanced interpretational approach might be achieved, as Judge Buergenthal suggests, by having stricter conflict of interest rules for arbitrators[77] or by having a general appeals procedure within ICSID, as proposed by the ICSID Secretariat.[78]

A thorough economic analysis of International Investment Law is still missing. There are intricate legal problems with a variety of actors (here, the "black box" of the state behaviour was not broken up in order to look to the internal processes determining external policy) which are difficult to model. Nevertheless, an attempt was made to show the basic lines of economic logic governing this issue area. This paper means to highlight some of the issues pressing in the current discussion of investment law; a modelling of the problems are on the research agenda.

[76] See e.g. CME Czech Republic B.V. v. Czech Republic (Final Award) (separate opinion of Ian Brownlie) (UNCITRAL, March 14, 2003), available at: http://www.cetv-net.com/iFiles/1439-seperate-op-pdf1403.pdf (last visited 5. 11. 2005).

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

[78] ICSID Secretariat. 2004. Discussion Paper, Possible Improvements of the Framework for ICSID Arbitration, available at: http://www.worldbank.org/icsid/highlights/improve-arb.pdf.

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