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Michael Waibel, Asha Kaushal, Kyo-Hwa Liz Chung & Claire Balchin

The Backlash against Investment Arbitration

Perceptions and Reality

Wolters Kluwer
Law & Business

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Edited by

Michael Waibel

Asha Kaushal

Kyo-Hwa Liz Chung

Claire Balchin

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AUSTIN BOSTON CHICAGO NEW YORK THE NETHERLANDS

Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd.
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Printed on acid-free paper.

ISBN 978-90-411-3202-4

Printed in Great Britain.

Foreword to the Backlash against Investment Arbitration

*Detlev Vagts**

The backlash that is the subject of this book has two components. One relates to procedure, that is, to arbitration of investment disputes. The other is a matter of substance, that is, the extent of the protections granted to foreign investors by treaties on investment. As to both components, states receiving investments are rethinking the costs and the benefits they derive from these arrangements.

For a full perspective on these developments, one needs to go back in time to the period before the expansion of foreign direct investment rules to which the backlash relates. This is the period characterized by the Charter of Economic Rights and Duties of States of 1974 (CERDS). In that United Nations General Assembly resolution an overwhelming majority of the nations—including many that had recently been freed from colonial status—voted to assert sweeping sovereignty both as to the right of states to apply their own law to regulate foreign investment and the right to determine what compensation should be given to foreigners whose property they seized "unless it is freely and mutually agreed . . . that other peaceful means be sought." CERDS had been preceded by progressively more strident resolutions captioned "Permanent Sovereignty over Natural Resources," passed in 1962, 1966, and 1973 and by a resolution called "Declaration on the Establishment of a New International Economic Order" of 1974. While the status of these resolutions as evidences of customary law was sharply contested, they set the tone for the period.

* Bemis Professor of International Law, Emeritus, Harvard Law School.

States were emboldened to take this position by the petroleum crisis of 1973, which was thought to presage a move toward higher prices and economic power flowing generally to less developed countries that relied on commodities. The movement also tapped into earlier attitudes, particularly in Latin America. Motivated by bitter experiences with European and US investors in the nineteenth century that included the use of force by the home governments, Latin American states rejected resort to international tribunals to resolve controversies with investors and creditors. Consistently with that attitude Latin American countries almost uniformly failed to ratify the Convention establishing the International Center for the Settlement of Investment Disputes of 1966 in the first two decades of ICSID. The name of the Argentinean international scholar Carlos Calvo is indelibly associated with this rejection of international arbitration. The Calvo Clause, which inserted these reservations into contracts with foreign parties, became a standard provision, particularly in Mexico. In the same vein states, particularly Mexico, denied that the Hull Rule calling for prompt, adequate, and effective compensation was in fact a rule of customary international law. Outside of Latin America, new states emerging from the colonial past joined in taking negative attitudes toward foreign investment. Indeed quite a few of them projected negative attitudes toward capitalism in general and entrusted their economies to state-owned enterprises. Of course, hostility to foreign investment was never universal. A few capital-exporting states not associated with colonialism or aggressive enforcement of investor rights were able to negotiate bilateral investment treaties as early as the 1960s.

The 1980s and even more so the 1990s generated a set of reactions against the CERDS approach. In a sense it was a first backlash, but from the opposite direction. The expected benefits to oil and other commodity producers failed to materialize. Indeed less developed states without petroleum resources had to pay high fuel prices to the lucky ones. The performance of state-owned enterprises generally proved to be disappointing.

Whereas the first leaders of the new nations had often been educated in European universities where socialism was in vogue a new generation was trained by academics who had converted to Thatcherism.

The successes of such private enterprise friendly countries as South Korea, Singapore, and the Republic of China impressed the governing classes of states in Latin America and Africa who had seen their economies stagnate. Finally, the USSR, which had served as an example of the supposed viability of state enterprise—and which had consistently supported developing countries in their opposition to capitalist/imperialist powers—collapsed. The Communist way of doing things continued only in Cuba and North Korea, hardly impressive testimonials for the economic performance of that genre. However much the Peoples Republic of China claimed to be continuing as a Communist state, it allowed ample room for private enterprise to flourish.

Policy changes followed these changes in thinking. Important state enterprises, including telecommunications systems and banks, were privatized. Native entrepreneurs were welcomed and encouraged. The reception accorded to foreign investors changed dramatically. States vied in designing programs to attract them.

They offered relief from normal tax burdens and regulations. Furthermore they undertook the policies reviewed in this book—the conclusion of investment protecting treaties that committed them to neither expropriate investments nor to burden them with treatment that was not fair and equitable. Furthermore, these agreements required the state to submit to arbitration of claims that these substantive rules had been violated. ICSID became a busy institution. Perhaps the high water mark of investor protectionism was represented by the amount of effort put into negotiating an agreement that would have made such protection multilateral rather than bilateral. The ghost of Carlos Calvo must have rolled in his grave.

It is unclear whether these arrangements produced the results sought by the states that entered into them. Much effort has been devoted to researching that question with strenuous use of modern mathematical modes of analysis. The jury is still out as to whether more investment flowed to those states that had entered into BITs than to those that did not do so. The issue is complicated by the fact that so many BITs have been concluded by so many states that no particular competitive advantage accrues to states that become parties.[1] Thus, there is considerable skepticism as to whether BITs are really useful for states seeking economic development.[2] But the heart of the backlash relates to the substance of BITs. As arbitral decisions multiplied some of them aroused concern that the exercise of sovereignty by governments was being unduly impaired. A series of cases arising under the North American Free Trade Agreement (NAFTA) seemed to pose a threat to governments' powers to impose new regulations designed to protect the environment. They seemed to provide foreign investors with more than national treatment. In the United States, the most unnerving litigation was that involving a Canadian firm called Methanex. It was engaged in the production of methyl tertiary butyl ether (MTBE), which was employed as an additive to motor vehicle fuels, because the mixture was supposed to diminish the severity of air pollution as compared with straight gasoline. It became apparent, however, that MTBE introduced problems into underground water supplies. Even a miniscule amount of MTBE, if it leaked from a fuel storage tank, could contaminate water to the point that it became undrinkable. The state of California began to impose regulations that in effect ended the additive program there. And the Canadian firm resorted to arbitration, claiming damages of US $970 million. That set off alarm bells in Ottawa, Washington, and Mexico City, and the three governments issued a joint interpretation of the rules in the NAFTA treaty that narrowed the protection given to

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1. *See* Zachary Elkins, Andrew Guzman & Beth A. Simmons, *Competing for Capital: The Diffusion of Bilateral Investment Treaties*, (1960–2000) 60 INT'L ORG. 811–46 (2006), reprinted in this volume, 369 (including a review of the literature on whether BITs achieve their stated objective).
2. Mary Hallward-Driemeier, Do BITs attract foreign direct investment? World Bank Policy Research, Working Paper Series, No. 3123 (2003); Jennifer Tobin and Susan Rose Ackermann, Foreign Direct Investment, Yale Law and Economics Research Paper No. 293 (2005); for a recent overview see the various contributions in Lisa E. SACHS & KARL P. SAUVANT, THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES AND INVESTMENT FLOWS (2009).

investors. The three governments were all relieved when the arbitrators turned back Methanex's claim. One result of this turn against restrictions on governments was a rewriting in 2004 of the US Model BIT agreement to loosen restraints on governments. Evidently, the United States realized that it might be subject to claims put forth by other parties to BITs even though that had not been anticipated when the BIT program was inaugurated. Efforts to negotiate a multilateral treaty on investment faded away.

In Latin America, too, objections to BITs began to emerge. The causes of mounting skepticism related to some degree to the economic problems of such countries as Argentina.[3] Commentators challenged the appropriateness of arbitration in cases involving public indebtedness such as bonds. Reactions against arbitration were also connected with the rise to power of leftist regimes, such as those of Venezuela and Bolivia, that wanted to reverse the policy of openness to foreign investment. They were strengthened by the reverberations of the global financial crisis of 2008, which caused especially painful shocks to developing countries. The pressure to denounce BITs and arbitration clauses grew. The spirit of Carlos Calvo has walked again.

Alongside complaints about the substance of investment agreements unease about the procedures of tribunals has been activated. It is asserted that the procedures for deciding cases are shaped by private commercial practices that are unsuitable for such public controversies as those that rise under BITs. Here are issues about the ability of the public in general and interested parties in particular to keep track of proceedings and make their views known. There are criticisms to the effect that the choice of arbitrators is skewed in the direction of investors because they come from a community of lawyers from metropolitan financial law firms who come to decision-making with a spin in the direction of investors.

It is therefore an appropriate time for this volume to review controversies about investment arbitration. Chapters in this volume explore the aptness of these complaints and in some cases suggest improvements. Some chapters are written by established figures in the scholarship of foreign investment and others by newcomers probing into the assumptions of that scholarship. There are of course limits to the extent to which they can predict future developments, which depend on the uncertain future of the world economy as well as policy decisions by states and investors. But familiarity with these questions will prepare the reader to adjust to an evolving investment environment.

3. *See* William Burke-White, THE ARGENTINE FINANCIAL CRISIS: STATE LIABILITY UNDER BITS AND THE LEGITIMACY OF THE ICSID SYSTEM, 407, and KATHRYN KHAMSI, COMPENSATION FOR NON-EXPROPRIATORY INVESTMENT TREATY BREACHES IN THE ARGENTINE GAS SECTOR CASES: ISSUES AND IMPLICATIONS, 165, for background on the Argentinean financial crisis.

Biographies of Editors

MICHAEL WAIBEL is a British Academy Postdoctoral Fellow at the Cambridge Faculty of Law and the Lauterpacht Centre for International Law. He is also a Bye-Fellow of Downing College. His current research focuses on the insolvency of states in international law. He also serves as co-rapporteur of the ILA study group on sovereign insolvency. In 2008, the American Society of International Law awarded him the Deak prize for his AJIL article "Opening Pandora's Box: Sovereign Bonds in International Arbitration." Michael graduated with Mag. iur. and Dr. iur. degrees from the University of Vienna, an MSc (Econ.) from the LSE, and an LLM from Harvard Law School. His work experience includes the ECB, the IMF and the World Bank. He has taught economics at the LSE and at Harvard, and is admitted to practice in New York.

ASHA KAUSHAL is a lawyer with substantial experience in international investment law. She has represented clients before international arbitral tribunals established under BITs, NAFTA and international commercial contracts. Asha has acted in matters before various Ontario courts and the Federal Court of Canada, and served as a law clerk to the judges of the Ontario Court of Appeal. She has authored articles in international arbitration journals, including the Global Arbitration Review and the International Arbitration Law Review. Asha graduated with a BA from McGill University, an MSc (Econ.) from the LSE, an LLB from Osgoode Hall Law School, and an LLM from Harvard Law School. She is presently a PhD candidate in Law at the University of British Columbia.

KYO-HWA (LIZ) CHUNG is a lawyer at Kim & Chang in Seoul, Korea with extensive experience in representing Korean and international corporate clients in international commercial arbitrations, as well as numerous cross-border litigations. She also has substantial experience in advising corporate clients with respect to drafting and enforcing corporate compliance policies and codes of conduct, employee training, internal investigations and anti-corruption laws and regulations. Before entering private practice, Liz served as a judge in Seoul Central District Court and Seoul Administrative Court. She graduated with a BA from Korea University College of Law, and an LLM from Harvard Law School. She is admitted to practice in Korea and in New York. She is the author of several articles on administrative trial procedure and international trade disputes.

Claire Balchin is a lawyer specializing in international dispute resolution, with a particular focus on international commercial arbitration and investment arbitration. She is admitted to practice in New York. Claire is also a trained mediator and has worked with the Harvard Mediation Program. She holds a BA (First Class Honours) in law from Trinity College, Cambridge, a Maîtrise en droit from the University of Paris II-Panthéon-Assas and an LLM from Harvard Law School. Claire also serves as coach for the College of Law of England & Wales Willem C. Vis International Commercial Arbitration Moot team.

Biographies of Contributors

Nigel Blackaby is a partner in Freshfield's international arbitration group in Washington DC and head of the Latin America Dispute Resolution Group. Blackaby acts as counsel and arbitrator in ad hoc and institutional arbitrations with a particular focus on Latin America where he has acted in English, Portuguese and Spanish language disputes. He is an editor of *Arbitration International*, and has published widely on international arbitration. Blackaby holds law degrees from the University of Exeter and Aix-Marseille III and is an English solicitor.

Gabriel Bottini leads the International Affairs Department of the Attorney General's Office of the Republic of Argentina. Bottini has extensive experience in ICSID and UNCITRAL arbitrations, as well as in arbitrations under ICC rules, and has published extensively in the area. He teaches international law at the University of Buenos Aires and at the University of Palermo in Buenos Aires. Bottini holds a law degree from the University of Buenos Aires and an LLM from NYU Law School.

Tillmann Rudolf Braun currently serves in the Coordination Unit, Foreign Office, Berlin, Germany. He was Deputy Head, Directorate-General for External Economic Policy, Federal Ministry of Economics and Technology, Berlin. His professional responsibilities included *inter alia* negotiating BITs on behalf of the German Government. In spring 2009 term, he was a *Global Fellow from Practice & Government* and *Visiting Scholar* at New York University School of Law. He holds Ass. iur. (Second State Exam, Munich) and MPA degrees from the Harvard Kennedy School of Government, has published and lectured on International Investment Law and on Germany's BITs and is on the scientific board of the International Investment Law Center, University of Cologne.

Markus Burgstaller is an associate in the International Arbitration Group of Lovells in London. He has broad experience in advising both investors and states in international disputes. Before joining Lovells, Markus worked for four years as International Legal Advisor to the Austrian Chancellor. He is author of numerous publications on international and European law. Markus holds a master's degree in both law and legal philosophy from the University of Vienna, a master's degree in law from New York University and a Ph.D. in public international law from the University of Vienna. He is qualified as an Attorney and Counselor at law in New York.

William Burke-White is Assistant Professor of Law at the University of Pennsylvania School of Law (on leave). He currently serves in the Policy Planning Bureau of the US State Department. He has written widely on the structure of international legal regimes, the effectiveness of international courts and tribunals, international arbitration, human rights, international criminal law, State financial collapse, and transitional justice. Burke-White holds a Ph.D. and M.Phil. in international relations from Cambridge University, a J.D from Harvard Law School, and a B.A. from Harvard College.

Jennifer Doucleff an associate in the Paris office of Latham & Watkins, practices in the area of international commercial arbitration and dispute resolution. She has particular experience with international arbitrations conducted under ICC rules, as well as ad hoc proceedings. She has acted for a diverse range of companies including those active in consumer health, technology, biomedical testing and automotive industries. She has expertise in purchase price adjustment disputes, breach of contract claims in the context of joint venture partnerships and long-term distribution agreements, claims of contractual breaches of representations and warranties, and disputes involving allegations of fraud and misrepresentation. She advises on issues of contract drafting and interpretation, and has counseled international organizations on issues such as establishing principles for private-public partnerships. In addition, she has assisted in conducting internal investigations in response to allegations of corporate wrongdoing. She teaches a course on American legal principles in a business law Masters Degree program at Université Paris X, Nanterre. She has also contributed to a chapter published in the International Contract Manuel, a Thomson/Reuters publication (2008), entitled "Managing International Political Risk."

Zachary Elkins is an Assistant Professor in the Department of Political Science, University of Illinois. His research focuses on comparative political science, political economy and quantitative methods in the social sciences, supported by a National Science Foundation Grant. He holds a PhD from University of California, Berkeley in Political Science, an MA from the University of Texas (Austin) and a BA from Yale.

Andrew Guzman is Professor of Law and Director of the Advanced Law degree Programs at Berkeley Law School, University of California, Berkeley. He holds a J.D. and Ph.D. (economics) from Harvard University. He has written extensively on international trade, international regulatory matters, foreign direct investment and public international law, and authored How International Law Works (OUP). Guzman is a member of the Institute for Transnational Arbitration's Academic Council and is on the board of several academic journals. Professor Guzman has taught as a visiting professor at several leading law schools in the United States and abroad.

Stephen Jagusch is a partner at Allen & Overy London specializing in international commercial and investment treaty arbitration, having acted as adviser and advocate in dozens of ad hoc and institutional international arbitrations, conducted in many countries, and subject to a wide variety of governing substantive and procedural laws. More recently, Jagusch has become recognized as an expert in the field of ICSID arbitration and disputes arising under BITs. He holds a BCom, LLB, MCom in Law (First Class) from Auckland University and is a barrister and solicitor of the High Court of New Zealand.

Amokura Kawharu is a Senior Lecturer in Law at the University of Auckland, and holds a BA/LLB (Hons) from the University of Auckland and an LLM from the University of Cambridge. Her research interests include international trade and investment law, and dispute resolution. Prior to joining the Auckland Law Faculty in 2005, she practised as a commercial law solicitor for a number of years in New Zealand and Australia.

Kathryn Khamsi is an Associate at Shearman & Sterling LLP, practicing in the International Arbitration group based in Paris. Previously, she was Legal Advisor to, and eventually also Coordinator of, the Timor Sea Office, the part of the Government of Timor-Leste mandated to conduct maritime boundary negotiations and draft a petroleum investment regime for the country. She has also worked for the International Development Law Organization in Kabul, Afghanistan and for The Carter Center on matters concerning mining investment contracts in the Democratic Republic of Congo. Khamsi holds an AB from Harvard (cum laude), an LLB and BCL from McGill (with distinction), and an LLM from Columbia (James Kent Scholar).

Christina Knahr is a postdoctoral researcher at the University of Vienna. Previously, she was an Assistant to Austrian MEP Dr. Marilies Flemming in the European Parliament in Brussels. Christina Knahr holds a Mag. iur. and Dr. iur. degrees from the University of Vienna and an MPA from the Harvard Kennedy School of Government. She wrote her doctoral thesis on "Participation of Non-State Actors in the Dispute Settlement System of the WTO: Benefit or Burden?," and has edited three books and published a number of articles in the field of investment arbitration.

Richard Kreindler is a Partner of Shearman & Sterling LLP, resident in its Frankfurt office, and has specialized in international arbitration and litigation matters since 1985. He is a member of the New York and Paris Bars. He has handled numerous commercial, construction, infrastructure and investment arbitrations throughout the world under the rules of the leading arbitration regimes and institutions as counsel, party-appointed arbitrator, sole arbitrator and chairman. He has published widely on international dispute resolution topics. He is a graduate of Harvard, Munich, Columbia and Münster Universities and is an Adjunct Professor of Law at the Universities of Münster, Germany.

Alexis Martinez is an Associate with Baker & McKenzie's International Arbitration Practice Group in London where he practices international arbitration and public international law. He has acted as counsel in 12 investment treaty arbitrations on behalf of both investors and states. He has also assisted arbitrators in many investment arbitrations. Alexis is a visiting lecturer at King's College, London where he teaches international commercial arbitration. He is an avocat at the Paris bar and a solicitor in England and Wales. Alexis holds a DEA in International Economic Law from the University of Panthéon-Assas (Paris II).

Ilija Mitrev Penusliski is a visiting researcher at Harvard Law School focusing his research on international law. He holds an LLM from Harvard Law School and a MJur from Oxford. Previously, he worked for the United States Agency for International Development, the European Agency for Reconstruction and the Government of Macedonia.

Timothy Nelson is a partner in the International Litigation and Arbitration Group of Skadden, Arps, Slate, Meagher & Flom LLP, New York. He has extensive experience representing clients in both litigation in federal and state courts as well as in arbitration before international and domestic arbitral bodies, such as the AAA/ICDR, the ICC, the ICSID and tribunals formed under the UNCITRAL rules. He also has experience in federal and state courts of appeal, including several significant cases involving the interpretation and application of the US Federal Arbitration Act (FAA). He holds a B.A. and L.L.B. from the University of New South Wales, and a B.C.L. from University of Oxford.

William (Rusty) Park is Professor of Law at Boston University. His practice and teaching focus on international financial and commercial transactions. After studies at Yale and Columbia, Park practiced law in Paris for several years. His books on international dispute resolution include ICC Arbitration, International Commerical Arbitration and Arbitration of International Business Disputes. In 2008 he was appointed by the United States to the ICSID Roster of Arbitrators. Park is General Editor of *Arbitration International* and a Vice President of the London Court of International Arbitration. He has served as chairman, sole arbitrator and party-appointed arbitrator in ICC, AAA, LCIA, ICSID, IACAC, UNCITRAL, NASD and ad hoc proceedings.

Facundo Perez Aznar serves as counsel in the International Affairs Department of the Attorney General's Office of the Republic of Argentina. He has substantial experience in ICSID and UNCITRAL arbitrations. Perez Aznar teaches International Law at the University of Buenos Aires, the University of Palermo (Argentina) and the Catholic University of Argentina. He holds a Law Degree from the National University of La Plata and a *DEA* from the Graduate Institute of International Studies in Geneva.

Luke Eric Peterson is a New York City-based journalist and analyst writing for a variety of media outlets and research institutions. He is the Editor of a widely read electronic news service, Investment Arbitration Reporter (www.iareporter.com). He also contributes to the Financial Times on investment arbitration matters, and is a columnist for the FT Group's FDI Magazine. He is a graduate of University College London, University of Oxford and the University of New Brunswick.

August Reinisch is professor of international and European law at the University of Vienna and professorial lecturer at the Bologna Center/SAIS of Johns Hopkins University. He has published widely in various fields of international law with a recent focus on international investment law, the law of international organizations, international responsibility, human rights and non-State actors. August Reinisch holds Mag. phil, Mag. iur. and Dr. iur. degrees from the University of Vienna and an LLM from NYU Law School. He is admitted to the Bar of New York and Connecticut.

Caroline Richard is an associate in Freshfields' international arbitration group in London. She has represented foreign investors in international arbitrations under the auspices of ICSID and UNCITRAL and has acted in disputes in the gas, electricity, mining and telecommunications sectors. Caroline holds law degrees from Harvard Law School, Cambridge University and Université of Montréal. She is admitted to the New York Bar and the Law Society of Upper Canada.

Stephan Schill is a Senior Research Fellow at the Max Planck Institute for Comparative Public Law and International Law in Heidelberg. Formerly, he worked as the International Arbitration Law Clerk to the Hon. Charles N. Brower, 20 Essex Street Chambers, London and as a law clerk to Judge Abdul G. Koroma at the International Court of Justice. He is admitted as an attorney-at-law to the bars in Germany and in the State of New York.

Christoph Schreuer is a graduate of the Universities of Vienna, Cambridge and Yale. Over an academic career spanning more than 40 years, he has published numerous articles and several books in the field of international law. He has covered such diverse areas as human rights, adjudication by national and international courts and tribunals, sovereign immunity, the law of international organizations, the sources of international law and the future of sovereignty. Since 1992 he has concentrated on international investment law and has written many articles on the subject. The main product of this activity is a 1,600 page commentary on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States under the title "The ICSID Convention: A Commentary." He has spent much of his academic career at the Department of International Law of the University of Salzburg, Austria. From 1992 to 2000 he was the Edward B. Burling Professor of International Law and Organization at the Paul H. Nitze School of Advanced International Studies (SAIS) of the Johns Hopkins University in Washington, D.C. From October 2000 to September 2009 he was Professor of International Law at the University of Vienna, Austria. Since December 2008 he is Of Counsel with the law office Wolf Theiss Vienna.

Thomas Schultz is a Senior Lecturer in the Faculty of Law at Geneva University, where he works on international dispute settlement. He is the Executive Director of the *Geneva Master in International Dispute Settlement* (Geneva University Faculty of Law and Graduate Institute of International and Development Studies), and the founder and Managing Editor of the *Journal of International Dispute Settlement* (Oxford University Press). Thomas is also in charge of the doctoral school in international dispute settlement of Geneva Law Faculty. He has authored the books *Information Technology and Arbitration* (Kluwer 2006), *Réguler le commerce électronique par la résolution des litiges en ligne* (Bruylant 2005) and, with Gabrielle Kaufmann-Kohler, *Online Dispute Resolution* (Kluwer 2004). His law review articles have appeared in journals such as the *European Journal of International Law*, the *Yearbook of Private International Law*, and the *Yale Journal of Law & Information Technology*. His work is used as reading assignments at Stanford Law School and Cambridge University. He is a member of the editorial board of the *Revue du droit des technologies de l'information.*

Beth Simmons is the Director of the Weatherhead Center for International Affairs and the Clarence Dillon Professor of International Affairs in the Department of Government at Harvard University. Her fields of interest are International Relations, International Political Economy, and International Law. Her publications include *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years, 1923–1939* (Princeton University Press, 1994), winner of the 1995 Woodrow Wilson Award, and a large number of articles in peer-reviewed journals.

Jeff Sullivan is a senior associate in the London office of Allen & Overy and is a member of the International Arbitration Group. He has represented numerous corporate clients and States in disputes arising out of bilateral and multilateral investment treaties. Jeff also has a broad range of experience in international commercial arbitration, including under the ICC, LCIA and UNCITRAL rules. Jeff is a member of the Washington DC Bar and has also represented clients before the US federal courts.

Rachel Thorn, a partner in the Latham & Watkins Paris office, specializes in international commercial arbitration and international litigation. She has particular expertise in investor-State disputes, purchase price adjustment disputes and disputes involving the energy and construction sector under multiple governing laws and all major international arbitration rules, particularly the ICC and UNCITRAL Rules. Prior to joining the firm in 1998, Ms. Thorn was a law clerk to the Honourable Richard W. Goldberg, United States District Judge at the US Court of International Trade.

MEHMET TORAL is a doctoral candidate at the Law Faculty of Geneva University. He worked there in the Private International Law Department from 2005 to 2008, where he participated in research in international dispute settlement, investment arbitration, commercial arbitration and private international law in general, before going to spend one year in the University of Cambridge, as a visiting fellow at the Lauterpacht Centre for International Law.

ALEJANDRO TURYN serves as counsel in the International Affairs and Controversies Department of the Attorney General's Office of the Republic of Argentina. He has substantial experience in both ICSID and UNCITRAL arbitrations. He holds a Law Degree (Abogado) from Universidad de Buenos Aires, a Post-Graduate Diploma on International Investment Law and has taken and conducted several research seminars in the field of Public International Law and Investment. Turyn also teaches Public International Law as Adjunct Professor at the Universidad de Buenos Aires and as Associate Professor at the Universidad de Palermo.

DETLEV VAGTS is the Bemis Professor of International Law, Emeritus at Harvard Law School. He earned degrees from Harvard College and Harvard Law School, where he also served as a Note Editor of the Harvard Law Review. The author of numerous articles on international law, comparative law and international business transactions, Professor Vagts also wrote two leading casebooks, Transnational Business Problems (4th ed. 2008, Foundation Press) and Transnational Legal Problems (4th ed. 1994, Foundation Press). He is a former editor-in-chief of the American Journal of International Law. Prior to joining Harvard Law School, he practiced for several years in New York.

ANNE VAN AAKEN is the Max Schmidheiny Foundation Tenure-Track-Professor for Law and Economics, Public, International and European Law and was a Senior Research Fellow at the Max Planck Institute for Comparative Public Law and International Law, Heidelberg and is affiliated with the Max Planck Institute for Research on Collective Goods, Bonn. She is the acting Vice President of the European Association of Law and Economics. She holds a Masters degree in Economics from the University of Fribourg, Switzerland, a doctorate in law and is admitted to the bar in Germany.

GUS VAN HARTEN is an associate professor at Osgoode Hall Law School of York University. He was previously a lecturer at the London School of Economics. His research examines international and comparative aspects of public law. He is the author of *Investment Treaty Arbitration and Public Law* (Oxford University Press, 2007). Van Harten was educated at the University of Guelph, Osgoode Hall Law School, and York University in Canada, and obtained a PhD in Law from the LSE. He clerked for the Ontario Court of Appeal, and is admitted to the Ontario bar.

Louis Wells is the Herbert F. Johnson Professor of International Management at the Harvard Business School. He has served as consultant to governments of a number of developing countries, as well as to international organizations and private firms. His principal consulting activities have been concerned with foreign investment policy and with negotiations between foreign investors and host governments. Professor Wells received a BS in Physics from Georgia Tech and his MBA and DBA from the Harvard Business School.