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# The Backlash against Investment Arbitration

Perceptions and Reality



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# **The Backlash against Investment Arbitration**

Perceptions and Reality

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# 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.

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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.<sup>1</sup> Thus, there is considerable skepticism as to whether BITs are really useful for states seeking economic development.<sup>2</sup> 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).

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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.<sup>3</sup> 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.

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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.

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# The Backlash against Investment Arbitration: Perceptions and Reality

*Michael Waibel, Asha Kaushal,  
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Recent decades have seen a tremendous acceleration in international investment arbitration. A rapidly expanding web of international treaties has substantially increased the protection of foreign investment and given investors direct remedies against host governments. Yet over the last few years, cracks have started to appear in the investment regime. Investment arbitration now attracts a substantial amount of public scrutiny. With arbitrators sitting in judgment over a wide range of national policies, some stakeholders are challenging their legitimacy.

Even before the current boom of investment arbitration, Jan Paulsson presciently highlighted its fragile foundations: “Future prospects for this development in international arbitration may depend on whether national governments—many of whom may not have appreciated the full implications...take fright and reserve tracks. That may in turn depend on the degree of sophistication shown by arbitrators when called upon to pass judgment on governmental actions. Arbitration without privity is a delicate mechanism. A single incident of an adventurist arbitrator going beyond the proper scope of his jurisdiction in a sensitive case may be sufficient to generate a backlash.”<sup>1</sup>

Commentators increasingly see signs of such a backlash against the foreign investment regime.<sup>2</sup> This book, the outgrowth of a conference organized by the

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1. Jan Paulsson, *Arbitration without Privity*, 10 ICSID REV.-FOR. INV. L. J. 232 (1995) at 257.

2. James Crawford, Foreword to Zachary Douglas, *THE INTERNATIONAL LAW OF CLAIMS* xxi (2009) (“Some would say investment arbitration has reached its half-life” and is characterized by “a