1 Unanticipated consequences

The bilateral investment treaty (BIT) between Pakistan and Switzerland is one of more than 3,000 investment treaties signed by practically all countries in the world, particularly during the 1990s and early 2000s (Figure 1.1). The vast majority are bilateral and closely follow decade-old provisions going back to the 1959 agreement between West Germany and Pakistan – with one key exception. For whereas early investment treaties referred disputes to inter-state adjudication, BITs adopted in recent decades have included a broad and binding consent to investor–state arbitration. As realized by the attorney general of Pakistan, this made the treaties some of the most potent legal instruments in the global economy.

Today, foreign investors increasingly resort to treaty-based arbitration when disputes arise. Not all claims have to be made public, but by 2015 we knew of more than 600 filed against nearly 100 states. Most have been brought in recent years and the majority of respondents are developing countries. The claims have dealt with a very wide range of government activities. For although investment treaties emerged in response to the wave of expropriations during the post-colonial era, outright expropriation of foreign investments came out of fashion in the late 1970s. Instead, the vague terms of investment treaties have been

![Figure 1.1 The spread of bilateral investment treaties](image)
used to raise broader complaints about lacking transparency, stability, and predictability in government decisions affecting a large number of actors apart from claimants themselves. Investors have targeted measures at all levels of government, including legislative and judicial acts, and disputes have often been in vital areas of public regulation, such as environmental protection or the provision of key utilities.

Foreign investors have not always won. In the SGS case, for instance, Pakistan was fortunate to have the tribunal ultimately deny the claim. But almost three out of five concluded cases have been decided against the host state or settled on, typically, unknown terms. This has resulted in considerable controversy in recent years, particularly because some arbitrators have granted compensation for measures that may have been permissible in domestic legal systems of most developed countries.

Such expansive interpretations have raised eyebrows among critics, who argue that vague treaties have been used to give foreign investors too far-reaching protections. Moreover, the identity of arbitrators themselves has come under scrutiny. For unlike domestic judges, arbitrators have often been private commercial lawyers. And should private lawyers really be granted such extensive powers over public regulation made by

1 UNCTAD 2014a.
3 Waibel and Wu 2014; Van Harten 2013.
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sovereign states? Can they be trusted not to inflate the judicial scope of the regime in order to boost the number of claims brought by investors?

Also, whereas governments have routinely been told by arbitrators that they are not sufficiently stable and predictable in their dealings with foreign investors, arbitrators themselves have taken inconsistent, and occasionally contradictory, positions. In the SGS case, for instance, one of the clauses appeared to the tribunal ‘susceptible of almost indefinite expansion’ and it ultimately ruled in favour of Pakistan by taking a narrow interpretation.4 Five months later, however, a contradictory interpretation of a largely similar clause went in SGS’s favour in a separate claim against the Philippines. This is but one example of how the vague nature of investment treaties combined with an ad hoc dispute settlement process has made investment treaty arbitration often unpredictable, which makes it difficult to foresee exactly which measures violate the treaties, and why.

Another set of concerns relate to the size of the monetary awards.5 In 2003, for instance, one dispute led to more than $350 million in damages against the Czech government including interest, which was equal to the entire health budget of the Czech government and effectively doubled the public-sector deficit for that year.6 This was a glimpse of what was yet to come. Nine years later a split tribunal awarded an American company $2.37 billion in compensation from Ecuador including interest, despite acknowledging that the investor had broken Ecuador’s own laws as well as the contract with the Ecuadorian government.7 The award amounted to almost 7 per cent of the Ecuadorian government’s total government budget and, adjusted for GDP, an equivalent award against the United Kingdom would be almost $70 billion and for the United States $458 billion.

Then finally, in 2014, Russia was asked to pay $50 billion to shareholders of the defunct oil company Yukos, amounting to 12 per cent of the government’s total revenue.8 Just the legal fees involved were staggering: the shareholders paid Shearman and Sterling, an American law firm, $74 million to represent them and the tribunal took almost $9 million for themselves – $7.4 million to the three arbitrators and $1.4 million to their assistant.9 These cases were extreme, of course, and the

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5 For statistics, see Franck 2007; Gallagher and Shrestha 2011; Hodgson 2014; Rosert 2014.
7 ICSID Case No. ARB/06/11, Award, 5 October 2012. 8 Rosert 2014. 9 Ibid.
10 "The Cost of Yukos," Global Arbitration Review, 29 July 2014. About 4 per cent of the arbitrators’ costs were to cover personal expenses. On top of that a further $1.3 million
Yukos claim did in fact involve outright expropriation. Yet, they highlight the potential liabilities that investment arbitration can impose on states.

So given the scope and interpretive practice of investment treaty arbitration, it should come as no surprise that the regime has become one of the most controversial areas of global economic governance. As one arbitrator has lamented: ‘the more [people] find out what we do and what we say, and how we say it, the more appalled they are’.\(^\text{11}\) This includes policy-makers in a growing number of developing countries. By 2015, several countries had decided to withdraw from the regime after coming on the receiving end of controversial investment treaty claims.\(^\text{12}\) South Africa had begun terminating its BITs, and Bolivia, Ecuador, and Venezuela had left the International Centre for the Settlement of Investment Disputes (ICSID) and cancelled some of their investment treaties. Also Indonesia was considering following suit, and India had put a hold to negotiations in order to rethink its investment treaty programme.\(^\text{13}\)

Most other developing countries have stayed in the regime for now and instead pursued more incremental reforms, but there is no doubt that the legitimacy of investment treaty arbitration has been put to the test in recent years.

Yet, the vast majority of respondent governments have nevertheless complied with awards promptly and voluntarily. The main calculus has been that in the absence of overriding political concerns it would be imprudent to sign up to investment treaties and the ICSID Convention to attract investment and then proceed to scare away the same investors by refusing to comply with awards. Also, the very few states that have postponed payment of awards have faced significant political and legal challenges. For instance, when Argentina initially refused to pay a number of outstanding ICSID awards owed to American companies, Washington suspended trade benefits to the country and sought to block international credit from the World Bank and the IMF. President Kirchner finally relented and decided to settle the outstanding ICSID awards, paying out half a billion dollars to five American companies.

Some investors have also taken the matter in their own hands and used the ICSID and New York Conventions to confiscate assets of the

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11 Comments by Johnny Veeder QC at Wilmer Hale seminar on international arbitration, 23 April 2014.
13 See ‘Indonesia to terminate more than 60 bilateral investment treaties’, *Financial Times*, 26 March 2014; Ranjan 2014.
respondent government. This is neither easy nor cheap due to sovereign immunity laws, but it is possible, and at the time this book went to press, President Putin could expect Yukos shareholders to try to enforce their award around the globe for years to come. Yet, in the vast majority of cases this hasn’t been necessary as international investment law is no different from other international regimes, where ‘almost all nations observe almost all principles of international law and almost all of their obligations almost all of the time’.15

This raises a significant puzzle. For why did practically all developing countries suddenly rush to sign largely identical treaties, which significantly constrained their sovereignty? Why did they expose themselves to expensive investment claims and give such a remarkable degree of flexibility to private lawyers to determine the scope of their regulatory autonomy? This is the core question of this book.

Traditional accounts

Crucial credible commitments

The standard answer from political scientists and a large number of legal practitioners is straightforward: if developing countries wanted to attract investment they had to sign the treaties. Because without offering recourse to investment treaty arbitration, developing countries couldn’t give risk-averse foreign investors a credible commitment that their investments would be safe. The theory is simple. As a starting point, developing country governments are expected to not fully internalize the costs of regulating foreign investors. They favour local firms at the expense of foreigners, even when the latter are more efficient.16 This is typically explained in terms of a dynamic inconsistency problem, where governments have an incentive to renege on promises made to foreign investors after their investments have been sunk in the host state.17 This could be through outright expropriation or more indirectly through changes in tax codes, requirements for local content requirements, repatriation restrictions, introducing new operation fees, and so forth. Although rational ex post this has negative ex ante implications, as foreign investors are aware of these risks and therefore refrain from otherwise efficient investment

14 See e.g. Peterson and Balcerzak 2014.
15 Henkin 1979, p. 47. See generally; von Stein 2013.
16 See discussion in Bonnitcha and Aisbett 2013.
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decisions. According to the standard narrative, investment treaties credibly commit against such behaviour by raising the costs of existing and future governments to extract value from foreign investors, which in turn should make them more attractive investment decisions. By signing investment treaties, developing countries thereby traded their sovereignty for credibility as this was the ‘cost of seeking additional FDI inflows’. Although this assumption underlies a large share of political science literature on the international investment regime, it is unconvincing. First of all, during the time investment treaties spread rapidly, the long-term reputational costs of mistreating foreign investors prevented (most) developing countries from taking the types of measures foreseen by obsolescent bargaining models. Although there were, of course, examples of egregious conduct against foreign investors during the 1990s, most developing countries were strongly committed to attracting foreign capital, which meant regulatory risk premiums were often quite limited even in ‘high-risk’ sectors with major sunk investments.

In cases where uncompensated expropriation or other regulatory abuses of foreign investors were a genuine concern, political risk management could often be effectively handled through market-based strategies. Investors could enter into joint ventures with local companies, obtain financing from local creditors, structure investments over long time periods, or bring in powerful partners such as major foreign banks or public aid agencies. Such options ensure that the host country has a long-term interest in protecting foreign capital. And even if these business strategies were deemed insufficient, investors could still obtain investment insurance. Political risk insurance covers many of the same risks as investment treaties and is often a more direct, quick, and straightforward option of investment protection than the prospect of going through lengthy and expensive arbitration proceedings. Particularly when insurance providers are state sponsored, the host government has a strong incentive to protect the assets of foreign investors, as they may otherwise risk future aid and loans. As a result, ‘once the full cost of prospective action against an insured investor is realized, these

19 Montt 2009, p. 128. Although not deal with here, it is important to note that investment treaty protections could also, in theory, encourage inefficient investment decisions by preventing efficiency-improving government measures; Aisbett, Karp, and McAusland 2010.
21 Ramamurti 2003; Wells and Ahmed 2006; West 1999; Woodhouse 2006.
22 See e.g. Bekker and Ogawa 2013; Jensen 2005.
disputes often become “misunderstandings” which are quietly and successfully resolved. 23

Finally, the notion that investment treaties were the only instruments that could ‘tie governments to the mast’ of international law is inaccurate. Although they are not necessarily perfect substitutes for investment treaties, carefully drafted investment contracts can secure many investments with the same – or greater – standards, including recourse to international arbitration backed by the New York or ICSID Conventions. 24 Throughout the post-war era, international tribunals have recognized their jurisdiction over contractual disputes and relied on international law principles to provide meaningful compensation for both expropriation and other contractual breaches. 25 Contracts do not guarantee that host countries will uphold their commitments, of course, but neither do investment treaties. 26 Also, it is true that some investment treaty claims have been pursued by medium-size investors, who may not be in a position to negotiate advantageous contracts, but the majority of claims have involved investors in a contractual relationship with the host state, where the contracts have often included their own dispute settlement clause. 27 In those cases, the effect of investment treaties is mainly to provide investors yet another avenue to adjudicate the same dispute. Just like the claim by SGS against Pakistan.

In short, there is a wide range of options available to foreign investors concerned with political risks, including market-based mechanisms, political risk insurance offered by governments and private providers, as well as contracts with recourse to international arbitration. None of these instruments can eliminate political risks entirely, but they do make investment treaties less crucial commitment devices than typically assumed by political scientists.

It is therefore not surprising that only a few investors seem to have found the treaties critical when considering whether to invest in developing countries. Sophisticated firms occasionally set up holding companies in third countries to obtain protection, 28 but the treaties have hardly ever influenced where the investments are going in the first place. It can

23 West 1999. 24 See generally; Yackee 2008b; 2009b. 25 Yackee 2009b, pp. 61–2. 26 On why, and when, governments breach investor–state contracts, see e.g. Wellhausen 2014; Wellhausen and Johns 2014. 27 Bonnitcha 2014, pp. 76–7; OECD 2012a, p. 17; Van Harten 2013, pp. 122–4. 28 In the absence of ratified Brazilian BITs, for instance, Petrobras is reported to have invested abroad via third countries to obtain investment treaty protection; see wikileaks.org/cable/2007/05/07BRASILIA833.html. Accessed on 10 June 2013. See also ICSID Case No. ARB/02/18, Decision on Jurisdiction, 29 April 2004; ICSID Case No. ARB/06/5, Award on Jurisdiction, 15 April 2009; ICSID Case No. ARB/07/27, Decision on Jurisdiction, 10 June 2010.
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happen, but it is exceedingly rare. For instance, the World Bank published a survey of foreign investors in 1991 and concluded that BITs had a negligible, if any, role for investment decisions. Only ‘[p]rofessional advisors, such as accountants or merchant bankers, would be people to concern themselves with such minutia, only after detailed project planning was already underway’. The report noted that UK investors ‘rarely if ever take into account the existence of [a BIT] when deciding whether or not to invest’. Similarly, although German public institutions considered BITs to be effective investment promotion tools, the World Bank noted that ‘empirical evidence does not necessarily support this’, and evidence to sustain that the treaties promoted investment was ‘limited’. Interviews with Swedish investors similarly revealed that BITs were ‘relatively unknown and therefore have little to no impact on FDI flows’. American investors didn’t find BITs that important either. This was in contrast with double taxation treaties, which were considered crucial for FDI decisions.

Later surveys have largely confirmed this view. Nor have investment treaties been crucial for the financing of the vast majority of foreign investment projects, as even political risk insurers have rarely found them relevant when determining the availability and pricing of insurance for expropriation and other political risks. Germany’s tying of state-backed insurance to investment treaties has been important for German investors

29 When Venezuela ratified the Dutch BIT in 1993, for instance, the Dutch ambassador reported to his Danish counterpart that recourse to investor–state arbitration in the treaty was instrumental for Royal Dutch Shell’s participation in a large natural gas project, Cristóbal Colon, UM.400.E13.Venezuela.12. It is unclear from the report whether a binding arbitration clause in a contract could have been sufficient for Shell.
31 Ibid., p. 89.
32 Ibid., p. 135.
33 Ibid., p. 140.
34 Ibid., p. 199.
35 Ibid., p. 41.
36 For a review, see Poulsen 2010. See also Yackee 2010 (in-house legal counsel in American multinationals report that BITs are ineffective in protecting against political risks and the treaties are unlikely to be important for the vast majority of establishment decisions as senior executives are rarely aware of their existence); Economist Intelligence Unit 2011 (only a small minority of 316 executives find BITs very important for expropriation risk, though with somewhat higher figures for large investors and investors from industries with large sunk costs); Copenhagen Economics 2012 (European investors in China are rarely familiar with their relevant BITs and only a few find the treaties relevant for investment decisions); Economist Intelligence Unit 2015 (even the relatively small number of investors who said they found the treaties crucial had nevertheless invested in risky jurisdictions without treaty protections. BITs were found to be very important for investing in China, in stark contrast with 2012 Copenhagen Economics survey, but the authors suggest that much feedback was likely aspirational rather than reflecting real investment decisions, as the questionnaire was sent out during highly politicized discussions over the future of European investment treaties.)
on occasion, as we shall see, but most public and private providers of insurance rarely find the treaties crucial. As noted by this underwriter:

While they should perhaps have a role to play, I would say [BITs] are likely to be considered completely irrelevant by underwriters today and thus irrelevant for the pricing of risk insurance. . . . Rather than having a role in the investment decision, they are just an extra arrow in the lawyer’s quiver on the occasions where disputes arise.  

All in all, investment treaties have undoubtedly been significant for some establishment decisions of some investors — particularly when it comes to the legal structure of their investments — but the impact of the treaties on investment flows to the developing world has been small.  

At least to date. Because even if surveys indicated that BITs were less than crucial for establishment decisions in the past, a growing number of investors and underwriters could find the treaties to be increasingly important as they realize the potential of investment treaty arbitration. The spike in claims in recent years indicates that this is not unlikely. Yet, even if investment treaties are becoming slightly more important for investment flows, it still leaves the question of why governments in developing countries signed the treaties in such great numbers from the late 1980s to early 2000s. There were many ways in which developing countries could attract investment, so why did these agreements become so widespread? If only few investors cared about BITs, and that too only ‘after detailed project planning was already underway’, why were the treaties so popular?

**Coercion**

One answer could be that developing countries were somehow coerced into the regime. Critics of BITs occasionally argue that Western states relied on power-asymmetries to get developing countries to sign the treaties and that explains why there is no multilateral investment agreement.  

This is misleading. During the 1960s and 1970s the sceptical attitude towards foreign investment in large parts of the developing world meant Western states had difficulties getting the vast majority of developing country governments to sign on to BITs. When invited to negotiate,
most governments responded that protections enshrined in domestic laws were sufficient to protect foreign investors, and the book will present archival records showing that even small and weak capital importing states were able to resist Western pressure.

Rather than external imposition, it was internal reforms that led the way for the investment treaty movement. With the Latin American debt crisis and the drying up of official aid flows during the 1980s, a consensus emerged that attracting foreign direct investment (FDI) was key to economic development. In John Williamson’s 10-point list summarizing the ‘Washington Consensus’ towards development policies, a restrictive attitude towards FDI was considered outright ‘foolish’. Many developing countries agreed, and governments in practically all corners of the world began to liberalize their investment regimes. Fair and equitable treatment of foreign investors, compensation for expropriation at fair market value, and non-discrimination – all are principles that were not just enshrined in Western BIT templates, but also in many national investment codes and practices during this period.

Investment treaties seemed like the perfect instrument to complement domestic investment reforms. A judge from Sri Lanka’s Court of Appeal accurately summarized the attitude like this:

Although substantial aid is given by the developed countries and their agencies to the Third World countries, the latter are unhappy about the conditions attached to such aid programs. Thus, they prefer foreign direct investments, in which they are equal partners with the investors. … The concept upon which [BITs] are based, namely reciprocity, accords well with that thinking; the principle of reciprocity is in conformity with the concept of sovereignty.

So after they had begun liberalizing their investment regimes at home, practically every developing country began signing treaties enshrining the very protections they had resisted just decades before (Figure 1.3). This included Latin American countries as well as governments in the former Socialist block. Immediately before the end of the Cold War even the Kremlin had begun to negotiate investment treaties after Gorbachev embraced the virtues of international law and the Soviet leadership no longer saw foreign investors as ‘the last poisonous flowers on the dung-heap of capitalism’.

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40 Williamson 1990, ch. 2.  
41 Alvarez 2009, pp. 52–6; Monnt 2009, p. 129.  
43 See e.g. comments made by Gorbachev in the UN in Koh 1997, fn. 156.  
44 Sahlgren quoted in Sagafi-Nejad 2008, p. 92. Foreign investors were invited to enter into joint ventures governed by Soviet laws and regulations, but ‘with exceptions provided for by inter-state and intergovernmental agreements, which the USSR is part to’; Decree No. 49 of the USSR Council of Ministers 13 January 1987.