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I

Introduction: globalization and international investment law

> And the more important international economic interests grow, the more International Law will grow.
>
> Lassa Oppenheim, *International Law*, vol. I, § 51 (1905)

Economic interests are among the driving forces for creating and forging legal rules. Law, as a consequence, does not impose only normative guidance for individual behavior, but is itself a product of society, its needs, and preferences, and has the objective of sustaining social exchange. This holds true not only in the domestic realm but also at the international level. In fact, international law is developing, growing, and being refined at an unprecedented pace as the need for international legal rules abounds in reaction to the social and economic phenomenon of globalization.[1] Indeed, globalization, as one of the formative processes which affects today's cultural, political, and economic life virtually anywhere in the world, is gradually transforming international law from a simple tool to coordinate inter-State relations to an instrument that provides a legal structure for truly global social orders.

One of the characteristics of globalization is the growth of transborder economic activities: goods, services, and capital have progressively cast off territorial ties and circulate increasingly freely across borders.[2] This development not only enhances the options and choices of individual economic actors, both consumers and producers, but leads to expanding economic interdependences and to the increasing, yet still incomplete, integration of national economies into a global economic system.[3] At

[1] On the notion and concept of globalization from a sociological perspective see Beck, *What is Globalization*? (2000).

[2] For an historical account of economic globalization see Rourke and Williamson, *Globalization and History* (1999).

[3] Even though economic globalization is not a linear, nor necessarily an irreversible development, but rather an evolutionary process towards economic integration which has, up to this moment, not abided in a unitary and borderless economic space, we can

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the same time, the release of economic activity from territorial linkages challenges both the ability of States to regulate their economy[4] and their capacity to provide the legal institutions that are necessary for the functioning of a global economy.[5] Such institutions include, for example, the legal concepts of contract and property rights, as well as regulatory frameworks, compliance procedures and dispute settlement mechanisms that enable economic actors to unfold their activity and to structure economic exchange.

As a consequence, the demand for law as an ordering structure progressively shifts from the national to the international level. This shift can be witnessed with regard to international trade and monetary law, where the World Trade Organization (WTO) and the International Monetary Fund (IMF) and their respective legal regimes establish legal and institutional infrastructures that enable and enhance transborder economic exchange.[6] International trade law, for instance, contains principles of non-discrimination and anti-protectionism that, to a certain extent and subject to exceptions, enable competition in order for a global market to function. Similarly, international monetary law attempts to stabilize exchange rates in order to achieve monetary stability as a basis for international financial transactions and capital markets. International cooperation is necessary in these instances, because individual States struggle to provide the rules and institutions that are necessary for global economic exchange.

nevertheless understand such transborder economic activities as forming part of the economic system of the *Weltgesellschaft* ("global society"). On the understanding of the economy as a functional sub-system of society see Luhmann, *Die Wirtschaft der Gesellschaft*, pp. 43–90 (1988). On the concept of the "global society" see Luhmann, *Die Gesellschaft der Gesellschaft*, pp. 145–71 (1997); Luhmann, *Die Weltgesellschaft*, 57 Archiv für Rechts- und Sozialphilosophie 1 (1971).

[4] von Bogdandy, *Globalization and Europe*, 15 Eur. J. Int'l L. 885, 886 (2004).

[5] Institutions are understood in North, *Structure and Change in Economic History*, pp. 201 *et seq.* (1981), as "a set of rules, compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principals," or more plastically: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." (North, *Institutions, Institutional Change, and Economic Performance*, p. 3 [1990]). Institutions are characterized by constraints with a certain permanence and durability which are imposed on actors of any kind. Legal rules that impose restrictions on the behavior of individuals as well as legal requirements that concern the exercise of public power, therefore, qualify as institutions in this sense.

[6] See Jackson, *Global Economics and International Economic Law*, 1 J. Int'l Econ. L. 1 (1998).

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A International investment law as a building block of the global economy

The shift from national to international level holds equally true for international investment relations, where the demand for international investment law has amplified parallel to an increase in foreign investment flows since the end of the Second World War – and even more so since the end of the Cold War.[7] In fact, foreign investment often takes place in a situation that requires international cooperation as an ordering structure, not so much because of the element of transborder flows of investment, but due to the involvement of the host State as a sovereign actor. While host State and investor initially have largely converging interests in attracting and making investments, the situation changes once an investment has been made. As the investor's option to simply withdraw his investment and re-employ it elsewhere without severe financial loss is limited, the host State has an incentive to change unilaterally the original investment terms by changing an investment contract, amending the law governing the investment, or even expropriating the investor without compensation.[8] This so-called political risk stemming from opportunistic behavior of the host State not only increases the cost of investment for investors and consumers, it may even prevent the flow of foreign investment completely.[9] As a consequence, promoting and protecting foreign investment behooves the establishment of institutions that reduce political risk and outweigh incentives for the host State to act opportunistically in order for private actors to unfold foreign investment activities.

In the domestic context, the task of establishing institutions in order to ensure the proper functioning of the economy, and of imposing constraints on the government's power to regulate and to interfere in economic activities, is largely, but not exclusively, performed by the State and its domestic legal system.[10] Liberal legal systems, in particular, limit government to

[7] On the development of foreign investment flows see UNCTAD, *World Investment Report 2007*, pp. 3 *et seq.* (2007).

[8] This change in incentives after one party has started performing or placed an asset under the control of the other party is also described as a hold-up or dynamic inconsistency problem. See Williamson, *The Economic Institutions of Capitalism*, pp. 52 *et seq.* (1985); Guzman, *Why LDCs Sign Treaties that Hurt Them*, 38 Va. J. Int'l L. 639, 658 *et seq.* (1998). Unlike contractual situations where mutual obligations are carried out in a directly reciprocal and simultaneous manner, foreign investment is, therefore, comparable to contracts involving the performance of continuing obligations.

[9] See Cooter and Ulen, *Law and Economics*, pp. 195–200 (4th edn. 2004).

[10] See Furubotn and Richter, *Institutions and Economic Theory*, pp. 265–434 (1997); on the relation between the State and the economy in particular, see also pp. 265–78, 413–20;

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acting in accordance with pre-established rules and procedures and restrict its activity by granting rights to individuals and companies.[11] Adherence to the rule of law and the prohibition of expropriations, for example, seek to avoid public opportunism and rent-seeking behavior. At the same time, liberal legal systems allow private parties to engage in economic exchange by delineating property rights, by recognizing enforceable contracts, and by providing dispute settlement mechanisms in courts.

The existence of these institutions is crucial not only for individual investment decisions,[12] but also positively impacts economic growth and development. In fact, the link between the protection of property rights, contract enforcement, government according to the rule of law, and dispute settlement by independent courts, on the one hand, and macroeconomic growth, on the other hand, is stressed by institutional economics and buttressed by theoretical and empirical studies.[13] Conversely, the lack of these institutions is widely regarded as one of the reasons for low levels of foreign investment, for low income levels, and underdevelopment.[14] Even though increases in foreign investment inflows may in and of themselves not create growth,[15] protecting property rights, contract enforcement,

North, *Institutions,* pp. 27–69 (both pointing out that formal and informal, public and private arrangements provide the institutional backbone of any economic system).

[11] See Luhmann, *Grundrechte als Institution* (1965) (outlining an understanding of fundamental rights as performing a specific social function).

[12] World Bank, *World Development Report 1997*, pp. 34 *et seq.* (1997) (reporting the results of a survey concluding that investors primarily make their investment decisions dependent upon the credibility of States to ensure a predictable and stable legal framework).

[13] See Buscaglia, Ratcliff and Cooter, *The Law and Economics of Development* (1997); Platteau, *Institutions, Social Norms, and Economic Development* (2000). More recently on the connection between institutions and growth see Rodrik, Subramanian and Trebbi, *Institutions Rule*, 9 J. Econ. Growth 131 (2004); Acemoglu, Johnson and Robinson, *Institutions as the Fundamental Cause of Long-Run Growth*, in Aghion and Durlauf (eds.), *Handbook of Economic Growth*, vol. 1A, p. 385 (2005); Bénassy-Quéré, Coupet and Mayer, *Institutional Determinants of Foreign Direct Investment*, 30 World Econ. 764 (2007). Critical on the causality between political institutions and growth Glaeser *et al.*, *Do Institutions Cause Growth?*, 9 J. Econ. Growth 271 (2004).

[14] See *supra* footnote 13.

[15] On the causality relations between foreign investment and growth see Hansen and Rand, *On the Causal Links between FDI and Growth in Developing Countries*, 29 World Econ. 21 (2006); Chowdhury and Mavrotas, *FDI and Growth: What Causes What?*, 29 World Econ. 9 (2006) (both suggesting bidirectional causality between foreign direct investment and growth). See also Prasad *et al.*, *Effects of Financial Globalization on Developing Countries*, IMF Occasional Paper 220, paras. 45–70 (2003); Carkovic and Levine, *Does Foreign Direct Investment Accelerate Economic Growth?*, in Moran, Graham and Blomström, *Does Foreign Direct Investment Promote Development?*, p. 195 (2005). See further *infra* Ch. III.C.1.

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government according to the rule of law, and dispute settlement by independent courts is crucial for increased economic activity through foreign and local investment and economic growth more generally. Foreign investment activity, in turn, is thus widely regarded as having positive impacts on the host State economy.[16]

Yet, the legal systems of many developing and transitioning economies do not provide the institutions that are necessary to attract and sustain foreign investment and to integrate developing economies into a global market. Their national legal systems often struggle to provide a sufficiently stable and predictable legal framework that protects property and effectively restricts opportunistic conduct of the executive and the legislator. Furthermore, a significant number of countries have difficulties in setting efficient court-based dispute settlement mechanisms in place that are independent vis-à-vis the government and enable investors to enforce their rights against the State and private parties alike.

Against the backdrop of such insufficiencies in many domestic legal systems, international legal instruments have developed to accompany the worldwide increase in foreign investment flows. They respond to the need and interests of foreign investors and their home States for protection and to the desire of host States to attract foreign investment. The international legal framework consists of international treaties providing for the settlement of disputes between foreign investors and host States, instruments providing for investment guarantees, and more than 2,500 bilateral, regional and sectoral investment treaties that contain substantive standards for the protection of foreign investors against undue government interference.[17] These treaties typically grant national treatment, most-favored-nation treatment, fair and equitable treatment, and full protection and security, prohibit direct and indirect expropriations without compensation, and contain the consent of host States to investor-State arbitration.[18] By doing so, they provide a substitute for the

[16] Bhagwati, *Why Multinationals Help Reduce Poverty*, 30 World Econ. 211 (2007); but see Axarloglou and Pournarakis, *Do All Foreign Direct Investment Flows Benefit the Local Economy*, 30 World Econ. 424 (2007) (arguing that benefits from foreign investment inflows also depend on the specific industry sector affected in the host State). See also *infra* Ch. III.C.1.

[17] On the statistical increase of investment treaties see UNCTAD, *Bilateral Investment Treaties in the Mid-1990s*, p. 9 (1998); see further UNCTAD, *Recent Developments in International Investment Agreements (2006–June 2007)*, p. 2 (2007) (recording an aggregate of 2,573 bilateral investment treaties at the end of 2006).

[18] For general accounts of investment treaties and related instruments of investment protection see, for example, Dolzer and Stevens, *Bilateral Investment Treaties* (1995);

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failure of many domestic legal systems to provide institutions necessary for sustainable economic activities and economic growth.[19]

B International investment law, economic ideology and hegemony

Certainly, this function of international investment law is closely connected to the interests of those foreign investors and States that push for increasingly globalized markets and the legal framework that accompanies them. In particular, the economic and political power of capital-exporting States translates into structures that favor the economic system they prefer, that is, essentially the liberal, market-based model that relies on property rights and government according to the rule of law. This model of global economics is, in turn, a prolongation and projection of the models prevailing in the national economies of traditional capital-exporting States. Accordingly, in the political and legal debate about globalization, its benefits and discontents, international investment law has been the focus of much criticism. Not only the scope of property protection under international law[20] and the tension between investment protection and other competing policy concerns, such as environmental protection or labor standards, have attracted critical attention.[21] Also

Sacerdoti, *Bilateral Treaties and Multilateral Instruments on Investment Protection*, 269 Recueil des Cours 251 (1997); Sornarajah, *The International Law of Foreign Investment*, pp. 204–314 (2nd edn. 2004); McLachlan, Shore and Weiniger, *International Investment Arbitration – Substantive Principles* (2007); Lowenfeld, *International Economic Law*, pp. 467–591 (2nd edn. 2008); Dolzer and Schreuer, *Principles of International Investment Law* (2008); Muchlinski, Ortino and Schreuer (eds.), *The Oxford Handbook of International Investment Law* (2008).

[19] See also Ginsburg, *International Substitutes for Domestic Institutions*, 25 Int'l Rev. L. & Econ. 107 (2005).

[20] See, for example, Been and Beauvais, *The Global Fifth Amendment?*, 78 N.Y.U. L. Rev. 30 (2003); Porterfield, *An International Common Law of Investor Rights?*, 27 U. Pa. J. Int'l Econ. L. 79 (2006) (both criticizing the ambiguity of investor rights, such as fair and equitable treatment and the concept of indirect expropriation).

[21] On the tensions between investment protection and environmental protection see, for example, Strazzeri, *A Lucas Analysis of Regulatory Expropriations under NAFTA Chapter Eleven*, 14 Geo. Int'l Envtl. L. Rev. 837 (2002); Gantz, *Potential Conflicts Between Investor Rights and Environmental Regulation Under NAFTA's Chapter 11*, 33 Geo. Wash. Int'l L. Rev. 651 (2001); Verhoosel, *Foreign Direct Investment and Legal Constraints on Domestic Environmental Policies*, 29 L. & Pol'y Int'l Bus. 451 (1998); Stone, *NAFTA Article 1110: Environmental Friend or Foe?*, 15 Geo. Int'l Envtl. L. 763 Rev. (2003); Gudofsky, *Shedding Light on Article 1110 of the North American Free Trade Agreement (NAFTA) Concerning Expropriations*, 21 Nw. J. Int'l L. & Bus. 243 (2000); Wagner, *International Investment: Expropriation and Environmental Protection*, 29 Golden Gate U. L. Rev. 465 (1999).

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the way international investment rules are negotiated, concluded, and implemented has been criticized as constituting the product of hegemonic behavior of capital-exporting countries that aim at preserving their dominance in relation to politically and economically weaker States.[22]

To a certain extent, this critique is a prolongation of the battle of ideologies between more liberal and more communitarian approaches to the relationship between the individual and society in general, and to the gestalt of the global economy in particular. On the level of international investment law, this debate often crystallizes in opposing views on State sovereignty and societal self-determination versus the protection of property, in particular foreign property. Accordingly, much of the critique of international investment treaties focuses on the substantive balance – or, better, the alleged imbalance – between investment protection and competing interests of host States and their constituencies. It concentrates on the content and scope of the rules and principles contained in investment treaties and asserts that they carry unwarranted advantages for foreign investors and capital-exporting States. This critique, therefore, engages in a moral debate about the desirability, the advantages, and the disadvantages that a system of international investment protection has and which interests it favors.

The current study, by contrast, does not focus primarily on the substantive scope of international investment protection and the question of how a proper balance with competing interests of host States can or should be achieved. It does not engage in a moral and philosophical apology of property protection and liberal economics, but is based on the assumption that the liberal market model informs the development and functioning of global economics and international investment law, without however making investment protection immune from competing policy concerns.[23] The focus of this book is much more to show to what

[22] See Benvenisti and Downs, *The Empire's New Clothes*, 60 Stan. L. Rev. 595, 611–12 (2007). See also Chimni, *International Institutions Today: An Imperial Global State in the Making*, 15 Eur. J. Int'l L. 1, 7 *et seq.* (2004); Chimni, *Marxism and International Law*, Economic and Political Weekly, p. 337 (February 6, 1999); see also Chung, *The Lopsided International Investment Law Regime and Its Effect on the Future of Investor-State Arbitration*, 47 Va. J. Int'l L. 953 (2007). See further *infra* Ch. III.B.3.

[23] See Vandevelde, *The Political Economy of a Bilateral Investment Treaty*, 92 A.J.I.L. 621, 627 (1998) (arguing that "BITs present themselves as quintessentially liberal documents"); see also Vandevelde, *Investment Liberalization and Economic Development*, 36 Colum. J. Transnat'l L. 501 (1998) (emphasizing that BITs form part of a movement to liberalize the international economy while leaving States considerable leeway for intervention); Vandevelde, *Sustainable Liberalism and the International Investment Regime*,

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extent it is possible to perceive international investment law as part of the legal framework that emerges from and, at the same time, drives economic globalization.

While political and economic factors play a role in the development of international investment law, just as moral, political, and economic power shapes municipal societies and the legal and political rules they endorse for the organization of national economies, this book proposes to understand investment treaties in terms of the function they perform for the global economic system. Accordingly, it contrasts the hegemonic critique of investment law with the aspiration and objective of this field of international law to establish institutions that support the functioning of a market-based global economy and stresses that the body of investment law applies indiscriminately to capital-exporting and capital-importing States. This view becomes increasingly apposite the more the distinction between capital exporters and capital importers dissolves, and the more national economies integrate into a global economy.[24] In this perspective, it is less States and their economies that interact with each other in the international economic system but private actors engaging in competition. International investment law, in turn, is about providing the framework for private economic activity in an emerging global economic space.[25]

C The choice between bilateralism and multilateralism

The development of international investment law after the Second World War on the basis of bilateral treaties contrasts significantly with the multilateral development in other areas of international economic law, in particular international trade and international monetary law. While multilateralism dominated international relations in these fields through the establishment of international organizations, such as the General Agreement on Tariffs and Trade (GATT) and later the WTO, as well as the IMF, several approaches to establish a multilateral investment regime based on a multilateral treaty failed.[26] Instead, international investment

19 Mich. J. Int'l L. 373 (1998) (arguing that BITs represent at least a temporary consensus on a liberal order for international investment relations).

[24] See *infra* Ch. III B.3.

[25] *Cf.* Vandevelde, *A Brief History of International Investment Agreements*, 12 U.C. Davis J. Intl L. & Pol'y 157, 183 (2005) (considering pointing investment agreements as "instruments of globalization").

[26] See *infra* Chs. II. B and II E.

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law has developed on the basis of a myriad of bilateral, regional, and sectoral investment treaties. The structure of the international economy thus came to be compared with an unbalanced and unstable two-legged stool supported only by international trade and monetary law.[27] Indeed, this choice for bilateralism in international investment law seems surprising compared with the general decision for multilateralism in the other main areas of international economic relations.[28]

Both bilateralism and multilateralism are forms of international cooperation. The major differences between both forms relate to the number of parties to an international agreement and the nature of the rules governing inter-State conduct. From a purely formal perspective, bilateralism refers to ordering relations between States on a dyadic basis, whereas multilateralism concerns "the practice of coordinating national policies in groups of three of more states."[29] More importantly, however, multilateralism differs with respect to the nature of the obligations it creates. Unlike, for example, the imposition of unilaterally favorable standards of conduct by one hegemon upon several other States, a behavior that would qualify as multilateralism under the purely formal understanding, "multilateralism is an institutional form that coordinates relations among three or more states on the basis of generalized principles of conduct: that is, principles which specify appropriate conduct for a class of actions, without regard to the particularistic interests of the parties or the strategic exigencies that may exist in any specific occurrence."[30] It is thus primarily the nature of the rules that regulate inter-State relations rather than their pedigree that characterizes multilateralism.

Multilateralism in this understanding draws a clear distinction between form and content and posits that the core characteristic of multilateral rules is their generalized and non-discriminatory application to all participating actors, rather than the creation of these rules in two-party or multi-party settings. A classic example of such generalized principles are notions of equal treatment and non-discrimination that subject all States

[27] See Kline, *International Regulation of Transnational Business*, 2 Transnat'l Corp. 153, 154 (February 1993).

[28] It bears, however, noting that other areas of international economic law also know countermovements in the form of bilateralism and regionalism. See, for example, the contributions in Demaret, Bellis and García Jimenez (eds.), *Regionalism and Multilateralism after the Uruguay Round* (1997); Okediji, *Back to Bilateralism?*, 1 U. Ottawa L. & Tech. J. 125 (2003–2004).

[29] Koehane, *Multilateralism: An Agenda for Research*, 45 Int'l J. 731 (1990).

[30] Ruggie, *Multilateralism: The Anatomy of an Institution*, in Ruggie (ed.), *Multilateralism Matters*, pp. 3, 11 (1993).

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to the same standard of conduct independent of their relative factual power. In addition, multilateralism is characterized by "diffuse reciprocity," meaning that benefits from international cooperation are expected to derive over time without the participants being able to determine at the outset who the benefitting participants will be.[31] It thus presupposes uniform rules and standards of conduct for the States participating in a multilateral regime and equal participatory rights under the rules of the regime. Multilateralism thus has the aspiration of ordering international relations on the basis of universal principles.[32] Bilateralism, by contrast, is characterized by specific reciprocity, or *quid pro quo* bargains, and usually manifests itself in rules that favor the interest of the more powerful States.[33]

Consequently, multilateralism is also an alternative concept to a hegemonic order that is characterized by rules that unilaterally favor the hegemon's self-interests without placing other participating actors on an equal footing. However, it is necessary to distinguish between hegemonic elements in the realization of certain rules and principles governing international relations, and the hegemonic nature of the rules that emerge. In other words, even though hegemony may have influenced the process of establishing international cooperation in a specific context, the result of such hegemonic behavior is not necessarily a regime based on hegemonic and, therefore, non-multilateral rules and principles.[34] Instead, multilateralism, as it is understood in the context of this study, distinguishes between procedure and content and is premised on the content-based definition. Legal rules and principles, and the relation between States under a certain regime, are therefore considered as multilateral if they are based on non-discriminatory principles, independent of whether their generative process was influenced by hegemonic conduct.

The core difference between multilateralism and bilateralism as forms of international cooperation, therefore, concerns the nature of the relations among States. While bilateralism puts the State and its sovereignty center stage, assumes a primacy of national interests, and allows for preferential and discriminatory treatment among States depending

[31] Ruggie, *ibid*.
[32] *Cf.* Caporaso, *International Relations Theory and Multilateralism: The Search for Foundations*, in Ruggie (ed.) (*supra* footnote 30), pp. 51, 55 (1993).
[33] Ruggie, in Ruggie (*supra* footnote 30), p. 11 (1993).
[34] *Cf.* Ruggie (*supra* footnote 30), pp. 24–31 (1993) (analyzing the influence of American hegemony on multilateralism after the Second World War).

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