2009

Introduction: Yearbook on International Investment Law and Policy, 2008-2009

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Introduction

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Companies invest abroad for a variety of reasons; what is essential to these firms is that they seek to increase their international competitiveness. Countries attract foreign direct investment (FDI)—investments made by a resident entity of a foreign country with the objective of establishing a lasting interest in an enterprise resident in the host country—for a variety of reasons; what is essential to these countries is that they seek to advance their economic development. These two sets of interests overlap to a large extent: firms can bring a range of tangible and intangible assets (capital, technology, skills, access to markets, etc.) that are central to development, whereas countries have assets (natural resources, infrastructure, skills, etc.) that firms need for their production processes as well as the markets that firms require to sell their goods and services.

These interests, combined with competition among firms and countries, the liberalization of investment regimes, and advances in communication, transportation and information technologies, have driven the rapid growth of FDI and the rise of multinational enterprises (MNEs)—enterprises that control assets in two or more countries—during the past three decades. The first chapter of this book, by Persephone Economou, John H. Dunning, and myself, documents this development, its salient features and the key issues related to it, to provide the background for the subsequent chapters. It also discusses the impact of the current financial crisis and recession on future FDI flows: these flows reached an all-time record of $1.8 trillion in 2007, but they have declined by over 20% in 2008 and will decline even more so (perhaps by more than 30%) in 2009. Still, compared to $40–50 billion at the beginning of the 1980s, FDI flows have reached significant proportions. Moreover, as the stock of FDI has risen drastically (reaching $15 trillion in 2007), the global sales of the foreign affiliates of MNEs have grown as well, estimated at $31 trillion in 2007—roughly two times the amount of world exports.[1] This makes FDI considerably more important than trade in terms of the delivery of goods and services to foreign markets, and it underlines the importance of dealing with issues relating to the international investment law and policy regime.

1 UNCTAD, *World Investment Report 2008,* p. 10 (2008).

While the interests of MNEs and countries overlap to a significant degree, the context within which this overlap is defined, as well as the extent of this overlap, is determined largely by the regulatory framework governing FDI and the activities of MNEs. First and foremost is the national regulatory framework for FDI. I expect that future editions of this *Yearbook on International Investment Law and Policy* will contain a chapter reviewing regulatory developments at that level. Increasingly, however, national regulatory and policy approaches take place—and need to take place—within the parameters set by international investment agreements (IIAs), agreements that, in a substantial manner, address investment issues. Pride of place among IIAs belongs to bilateral investment treaties, of which some 2,600 were concluded by the end of 2007.[2] In Chapter 2, Peter Muchlinski traces the main recent developments concerning IIAs, including the continued growth in the number of IIAs and the diverse range of issues addressed by these agreements. He notes that, although the traditional "first generation investor protection model" of IIAs is still the most widely used, more recent agreements have been addressing some of the systemic issues that have come to light recently—in particular, the relationship between investor rights and regulatory discretion, and the effect of the increasing number of arbitral awards in investment disputes (discussed in more depth in Chapter 3).

Given that there are differences in the interests of investors and host country governments, it is not surprising that, at times, the relationships between the two can become conflictual. This is not new. What is new, however, is that a growing number of such conflicts are the subject of formal and public international adjudication, i.e. become disputes subject to international arbitration. That number has risen rapidly and reached at least 300 by mid-2008, with more than half of the disputes arising during the past five years.[3] In many ways this is not surprising, as the overwhelming number of IIAs allows investor-State disputes, and there are at least 80,000 MNEs with at least 800,000 foreign affiliates. Depending on the availability of an IIA and its applicable provisions, each of them (and, under certain circumstances, even individual shareholders) can initiate an arbitration case. As José Alvarez puts it, the international law system is enforced by the "private attorney generals" of MNEs.[4] Chapter 3, by Ian A. Laird and Borzu Sabahi, discusses recent developments in international investment arbitration. The authors focus in particular on several important issues addressed in investment arbitrations in 2007, including novel jurisdictional issues, issues related to the merits and standards of compensation in damages awards, and the limited power of annulment committees. They also note that although there is no formal rule of *stare decisis* in international investment law, several tribunals in 2007 directly referenced precedent, and there is an informal development of *jurisprudence constante* in investment arbitration.

The interest that investment disputes are beginning to attract in institutions of higher learning is reflected in the fact that foreign investment moot courts are becoming more popular. Moot courts such as these allow law students—the future practitioners and policy makers—to attain a practical understanding of the issues by representing investors

2 *Id.*

3 *Id.*

4 José E. Alvarez, Law of Empire, Ala. L. Rev. (forthcoming, 2009).

and host countries in hypothetical investor-State disputes. For this reason, the winning claimant and respondent memorials from the inaugural Foreign Direct Investment International Moot Competition held in November 2008[5] are included in a special section at the end of this volume.

Historically, natural resources accounted for an important part of FDI. This role greatly diminished during the 1970s, when, in a spate of nationalizations, host countries took over natural resource assets (although, in many cases, non-equity relationships remained). Still, FDI in natural resources accounted for 13% of world FDI flows in 2006 and 8% of its stock. With the recent rise in commodity prices and the stronger capacities of host countries, host countries have become more assertive, giving rise to a new resource nationalism. Hence, Albert Bressand examines, in Chapter 4, a range of issues relating to FDI in one sector that has received particular attention, oil and gas. He gives an overview of the rapid rise in energy demand and the key transformations reshaping the investment scene. Going beyond the one-size-fits-all view of "resource nationalism," the chapter distinguishes six different ways in which sovereignty and market considerations interact in strategically significant major resource-holding states. In three of these groups of countries, sovereignty considerations come first, yet this emphasis on sovereignty can range from an absolute ban on foreign investment in the upstream (and sometimes midstream and downstream) parts of the value chain to a strategically guided effort to strengthen the national oil and gas companies into major international players and investors in their own right. Special attention is given to the implications of the internationalization of national oil and gas companies in the more outward-oriented group of sovereignty-conscious countries, a group that includes countries as important as Russia, Kazakhstan, China, India, and Algeria. By contrast, in three other groups, market considerations come first, but environmental considerations, concerns for the security of supply, and efforts by governments to capture a larger part of the economic rent imply that sovereign objectives are never entirely absent. The challenges for international investors are discussed in light both of this analytical framework and insights from important microeconomic developments and specific oil and gas investments during the recent years.

These four chapters make up Part One of the *Investment Yearbook*. Future editions will update each of these areas, to keep readers abreast of salient developments in each of them.

Part Two, then, contains chapters that address key issues in international investment law and policy. Perhaps no question has led to more legal and policy debate in recent years than matters involving national security, essential security interests and similar concepts, and, in particular, the question of who judges the applicability of such concepts in a given situation. This discussion is foreshadowed in the chapter by Muchlinski, in which he discusses the increased attention to the question of "national security" and "essential security interests" in the context of FDI, and specifically in IIAs. Most of the

5 The co-founders of the FDI Moot are the Center for International Legal Studies (CILS) in Salzburg, Austria; Suffolk University Law School in Boston; Pepperdine University Law School in California; the Centre for Energy, Petroleum and Mineral Law at the University of Dundee in Scotland; and the German Institution of Arbitration in Cologne, Germany.

chapters in Part Two also deal with the question of what constitutes the appropriate balance between the rights and responsibilities of investors and those of governments. It is a question that, sooner or later, had to arise because the international investment law and policy regime, by design, has largely been created, first of all, to protect investors and then also to liberalize the conditions under which they operate; from a host country perspective, such a regime was meant to encourage FDI flows.[6] In fact, it is actually quite astonishing how rapidly the international investment law and policy regime has developed during the past few decades. To quote Jeswald W. Salacuse and Nicholas P. Sullivan regarding the status of this regime today: "In most cases, a foreign investor benefiting from a BIT [bilateral investment treaty] may now look to a comprehensive, specific, and largely uncontested set of international rules, with recourse to international tribunals for enforcement."[7]

While there is broad agreement that the evolution of the international investment law and policy regime is, indeed, an outstanding success, questions are increasingly being raised as to the nature of this regime and especially as to the balance of rights and responsibilities between governments and firms. At the moment, a good part of this discussion crystallizes around the question of how much leeway governments have to undertake actions that may contravene otherwise agreed treaty provisions, and who judges under what conditions this can occur.

In Chapter 5, I suggest that this discussion needs to be placed into a broader context, namely a certain reevaluation of the costs and benefits of FDI for host (and home) countries and the attendant effect on national regulatory frameworks for such investment. After two decades of a broad and strong consensus that FDI has an overwhelmingly positive impact on host countries and during which such investment flows grew substantially, a number of governments are taking a more skeptical attitude, be it for national security (however defined), economic development, or other reasons. The result has been, at the national level, that the overwhelming liberalization trend of FDI laws seems to be slowing down: for example, while some 95% of all changes in national FDI laws and regulations during 1991 and 2002 were in the direction of creating a more friendly investment environment, this percentage had dropped to 84% for the period 2003–2007.[8] Indeed, during 2006–2007, the countries worldwide that introduced at least one regulatory change making the investment climate *less* welcoming for MNEs accounted for 40% of all FDI inflows.[9] This suggests that a certain rebalancing of the national regulatory framework for FDI is taking place.

Importantly, there are also signs that a certain rebalancing may be happening at the international level as well. As Patrick Juillard argues, in Chapter 6, this is a response to

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6 On the influence of bilateral investment treaties (and double taxation treaties) on FDI flows, *see* Karl P. Sauvant and Lisa Sachs, eds., The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows (2009).

7 Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, Harvard Journal of International Law 46), 70 (2005).

8 UNCTAD, *World Investment Report 2008*, *supra* note 1.

9 Calculation of the author, based on UNCTAD data.

an international investment law and policy regime created with the principal objective of protecting foreign investors. He suggests that there is a growing feeling, including among governments, that bilateral investment treaties are "causing a gradual erosion of countries' rights to legislate in the public interest," and that the investment dispute settlement mechanism currently favors investors and "casts [States] in a no-win situation." He notes, as other authors in this volume do as well, that more recent BITs "tend to make more and more room for the preservation of State interests and, by so doing, start to strike a new balance between investors and States."

In fact, the more restrictive approach of the United States to such protection standards as fair and equitable treatment and cases of indirect expropriation, suggests that one of the chief promoters of an open international investment law and policy regime is beginning to take a more cautious approach when it comes to the rights of investors vis-à-vis governments. By comparing the 1994 and 2004 U.S. model bilateral investment treaties, Kenneth J. Vandevelde traces this change in treaty language systematically in Chapter 7. He notes that the 2004 model BIT strengthens the position of BIT parties vis-à-vis investors and, importantly, vis-à-vis the investor-State arbitral tribunals as well, reclaiming some of the power handed to the tribunals in the previous model BIT. Overall, he finds that the 2004 model "reflects a more cautious and tentative foreign investment policy."

This growing reluctance to entrust tribunals with vast interpretation authority is examined in one specific context by Stanimir A. Alexandrov and Joshua M. Robbins in Chapter 8. They delve into the relatively unexamined subject of proximate causation in international investment disputes, specifically noting the flexibility that investment tribunals enjoy in interpreting the multifaceted doctrine of "proximate causation," and the potential impact of such interpretations of findings of liability or damages. They explain how the pragmatic considerations may influence the application of proximate causation principles, especially when "the investor-State dispute resolution system comes under criticism," but they conclude that "only time and . . . scrutiny" will tell how it is applied in future cases.

These chapters echo (some more, some less) the sentiment of an increasing number of governments that the investor-State relationship at the international level—including IIAs and the investor-State dispute settlement mechanisms—pay too little attention to public interest concerns and to the regulatory needs of host governments. In this context, Charles H. Brower II, in Chapter 9, examines the political character of investment disputes and the reluctance of investor-State arbitral tribunals to consider openly and systematically the serious public interest implications of the issues at stake. The most significant obstacle to tribunals' systematic consideration of the public interest, he finds, is a combination of "practical difficulties and limitations imposed by the applicable law." Brower suggests, however, that general principles of treaty interpretation can be used to "bring investment treaty arbitration into a public law framework," thereby giving the public interest greater attention.

Nowhere is the change in attitude toward the current regime and the calls for a rebalancing of the regime in favor of the public interest more apparent than in the discussions surrounding the essential security exception in IIAs and the extent to which it is self-judging. Therefore several contributors in this inaugural volume of the *Investment Yearbook* specifically deal with various aspects of this problématique.

In Chapter 10, José E. Alvarez and Kathryn Khamsi discuss in detail how the essential security exception issue was dealt with in five Argentina arbitral decisions. They suggest that Argentina's defense of necessity in those cases "raises a number of interpretive questions that go to the heart of the . . . investment regime." After discussing the interpretive questions extensively, they find that the "measures-not-precluded" clause of the Argentina-U.S. BIT was not meant to be "self-judging," that it should be interpreted in light of the customary defense of necessity, and that, even if properly invoked, it does not excuse the obligation to compensate. Although they find some of the underlying concerns about the investment regime's legitimacy to be overstated, they also believe that the regime's genuine legitimacy concerns may require fixing the applicable substantive law. (Vandevelde, in his chapter, notes that the United States revised its Model BIT in 1998 to include language stating that the essential security exception of its (future) BITs *is*, indeed, self-judging—one of the several ways in which more recent BITs shift the balance away from investor protection toward regulatory flexibility. That later revision, however, does not retroactively apply to the U.S.-Argentina BIT concluded prior to the revision.)

Andrea Bjorklund, in Chapter 11, looks more closely at the customary international law defense of necessity, primarily through the lens of the ILC State Responsibility Article 25 and the Argentina arbitral decisions. While noting that some of the Argentine cases distinguish the Argentine-U.S. BIT's essential security provision from the customary defense of necessity, possibly setting a lower threshold for invoking the former, she concludes that the better interpretation of the treaty provision is that it incorporates the relevant provisions of the customary defense. The former approach raises two serious problems. First, there are no standards against which to measure when a state faces an "essential security" threat; incorporating the customary law standards alleviates that difficulty. Second, it is more likely to be inconsistent with the object and purpose of the investment treaty itself, which was designed to confer greater protections on foreign investors than would be available to them under customary law. Bjorklund also discusses the complicated question of whether compensation is owed in the case of a successful necessity defense, ultimately suggesting that it is unlikely to exculpate states from all of their compensatory obligations, but that it might reduce compensation owed to restitution.

Finally, in Chapter 12, Thomas Wälde returns to the broad canvas and examines not only the nature of the international investment law and policy regime but also discusses a range of proposals that have been made to improve its functioning. In particular, he deals with the questions of consistency, treaty content and negotiation, soft-law instruments, mediation, procedural reform of arbitral tribunals, transparency, and amicus participation. Although Wälde suggests that investment arbitration is "one of the most successful institutional reforms on the plane of international law," he nevertheless discusses some measures to improve the quality of the current investment arbitration regime, including the establishment of a legal aid facility for defendants, and the development of a practical arbitration manual to help newcomers navigate the investment dispute process.

What these various chapters show is that the international investment law and policy regime is evolving, and is likely to continue to do so in the future. Indications suggest

that this will lead to more circumscribed rights for investors on the one hand, and more flexibility for governments, in the form of a stronger right to regulate, on the other. At the same time, care needs to be taken to prevent this rebalancing from going too far and undermining a transparent, predictable, and rule-based system. In future editions, the *Investment Yearbook* will monitor these developments and examine their implications for the international investment law and policy regime, especially those relationships between governments and investors.

YEARBOOK ON INTERNATIONAL INVESTMENT LAW & POLICY

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OXFORD
UNIVERSITY PRESS

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Argentina Austria Brazil Chile Czech Republic France Greece Guatemala Hungary Italy
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Published by Oxford University Press, Inc.
198 Madison Avenue, New York, New York 10016

Library of Congress Cataloging-in-Publication Data

PU: Please provide CIP data. Also, please confirm whether we need to follow exact style as there in source folder for CIP data?

1 2 3 4 5 6 7 8 9

Printed in the United States of America on acid-free paper

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