

**International Investment Law and its Instruments:**

**Managing Risks to Investors and Host States**

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## List of Abbreviations

art.	Article
BIT	Bilateral Investment Treaty
BRICS	Members of the association of leading emerging economies: Brazil, Russia, India, China and South Africa
Cf.	Confer
Diss.	Dissertation/JD
ed.	Editor(s)
EMC	Emerging Market Countries
f./ff.	and following page(s)
FCN	Friendship, Commerce and Navigation
FDI	Foreign Direct Investment
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
IBRD	International Bank for Reconstruction and Development
ICC	International Chamber of Commerce
ICSID	International Centre for Settlement of Investment Disputes
IMF	International Monetary Fund
LCIA	London Court of International Arbitration
LDC	Lesser Developed Countries
MIGA	Multinational Investment Guarantee Agency
OECD	Organisation for Economic Cooperation and Development
OPIC	Overseas Private Investment Corporation
p.	Page
PRI	Political Risk Insurance
PSA	Production Sharing Agreement

SECO	Swiss State Secretariat for Economic Affairs
SERV	Swiss Export Risk Insurance
SCC	Stockholm Chamber of Commerce
TRIMS	Agreement on Trade-Related Investment Measures
UAE	United Arab Emirates
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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## Introduction

The question of whether the international network mechanism for the protection of investments is helping to promote sustainable project development, or whether it is, in fact, only exacerbating the problem of global poverty, is currently the focus of heated debate among prominent scholars at the interface of economics and the law. As a prefatory remark, and with an eye to the ongoing public dialogue between Joseph Stiglitz and Kenneth Rogoff,<sup>1</sup> let it be said that there is some room for hope that the criticism currently being directed at the world's investment institutions may eventually bear fruit. With the increase in transparency in communications, there is reason to believe that the evolving web of global law will succeed in giving higher priority to expectations of sustainability in dealing with foreign direct investment.

Whether, and in what way, the network of relationships that comprises the law of investment protection, that is, the aggregate of the relevant regulatory instruments, contributes to improved oversight over the “expected” sustainability, will be the subject of the present study. As one of the driving forces behind the international network mechanism for the protection of investments, the World Bank, for example,<sup>2</sup> focuses on the promotion of economic and social progress in the developing countries.<sup>3</sup> To this end, it grants long-term loans conditioned upon economic policy consultations (i.e., expectations in the form of a code of behavior) to ensure the use of the money as foreseen. In addition to serving as an intermediary for loans between countries, the World Bank has increasingly come to promote investment by privately owned

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<sup>1</sup> Stiglitz (2003); ROGOFF KENNETH, An Open Letter to Joseph Stiglitz, Washington D.C., 2 July 2002, available online at: <<http://www.imf.org/external/np/vc/2002/070202.HTM>>.

<sup>2</sup> See the World Bank website at: <[www.worldbank.org](http://www.worldbank.org)>. Also to be mentioned is the International Finance Corporation (IFC), also a member of the World Bank Group, which promotes open and competitive private sector markets in developing countries. The IFC supports enterprises from the private sector – both companies and financial institutions – with the goal of creating jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities so as to create the conditions for the local population to emerge from poverty. See the IFC website at: <[www.ifc.org](http://www.ifc.org)>.

<sup>3</sup> Cf. *Nobel* (2010), §3 at 183.

companies – *foreign direct investment (FDI)*<sup>4</sup> – as a source of funding, on the assumption that such a network mechanism can increase efficiency in addressing the practical needs of the developing countries.<sup>5</sup> In this connection, the World Bank and other organizations have also supported various initiatives designed to facilitate and secure such private investments. Under such favorable auspices, the role of private investment in developing regions has assumed an increasingly important role in international trade.<sup>6</sup> The opening of global markets along with new possibilities for relocating production facilities in low-wage countries have proved highly advantageous for investors.<sup>7</sup> For emerging markets and countries of the Third World, this has the potential of being a win-win situation, since private direct investments are subject to sustainability requirements and, at the same time, by creating employment, contribute to socio-economic progress for the local stakeholders. For the companies making such investments, the all-important preliminary step is the preparation of a business case,<sup>8</sup> including a risk assessment, to make as informed a decision as possible before initiating a new project. It is here that the legal framework created by the so-called BITs (Bilateral Investment Treaties) – agreements between countries for the coordination and protection of foreign direct investments<sup>9</sup> – can provide investors with a “nudge”<sup>10</sup> in the right direction. This framework offers companies explicit, substantive legal protection for the rights granted to them by sovereign act of the investment countries. Implicit therein, however, is also an infringement of democratic values in the host country. This incongruity will be addressed further below.<sup>11</sup>

The purpose of the present paper is to examine the effectiveness of BITs and similar instruments as a factor in assessing the risks involved in foreign direct investments – both for

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<sup>4</sup> For a definition of FDI, see below, p. 3f.

<sup>5</sup> Ziegler (2010), 690f.

<sup>6</sup> Lörcher (2001), 155f.; cf. also Nowak (2010) 155ff.

<sup>7</sup> Krajewski (2009), at 531.

<sup>8</sup> Feldhusen/Gebhardt (2008), 250: “Der Business Case ist ein Hilfsmittel zur Entscheidungsfindung und Planung, das erwartete finanzielle Ergebnisse und darüber hinausgehende Auswirkungen auf das Unternehmen vorhersagt.”

<sup>9</sup> Cf. Grubenmann (2010), 12.

<sup>10</sup> Cf. Thaler/Sunstein (2009), 5f. und 12ff.

<sup>11</sup> Lörcher (2001) 155f., fn. 6

investors and for the host countries, focusing, in particular, on the Less Developed Countries (LDC). What is the role of these instruments? How are they utilized? Following a discussion of the meaning of the term “investment,” I will take a closer look at the three main instruments employed for the protection of FDIs: the BITs, institutionalized investment arbitration (as offered by the International Centre for Settlement of Investment Disputes), and investment guarantees (as furnished by such entities as the (Multinational Investment Guarantee Agency). A more thorough understanding of the workings and effects of these instruments will make possible an analysis of their costs and benefits – both for investors and for the LDCs – in managing the risks associated with foreign direct investments.

## **I. Framing the meaning of “investment”**

To begin, it will be useful to determine the sense in which the term “investment” is used in international law within the context of FDI. How did the phenomenon of FDI arise? What are the main investment products? Where are the investment markets? And what are the various possibilities for making such investments?

### **A. Foreign Direct Investment in LDC**

Foreign direct investments can be broken down into two categories. The first includes investments in developed countries, whose leadership may occasionally decide to offer particularly advantageous terms to a foreign investor in order to benefit from a specific service. The second category is that of investments made in less developed countries by companies from economically more advanced countries. In the present paper the focus will be on the instruments of international investment law deployed in connection with investments in the LDCs, many of which, in addition to their lower standard of living and shaky industrial base, also suffer from a high degree of political instability. Most of these countries are former colonies, so that, historically, a need for international investment law in relation to LDCs was first felt with the dismantling of the colonial regimes.

As a rule, the government of a developing country, or a state-run enterprise, will enter into an agreement with a foreign investor for the purpose of carrying out jointly an investment

project.<sup>12</sup> From the point of view of the investor company, FDI can generally be characterized as the outsourcing of production to a foreign country, where human resources are available at advantageous conditions. Most often this will involve the creation of a new business entity, possibly in the form of a joint venture, or the acquisition of an existing entity in the investment country (cross-border mergers and acquisitions), so that the investor company can extend its operations to that country via the newly created, or newly acquired, branch or subsidiary there. The investment vehicle can be incorporated or unincorporated and includes, by convention, brings with it the ownership of land and buildings by private entities.<sup>13</sup> Another possibility is for the investor company to acquire a shareholding interest – assorted with voting rights – in a foreign company, whereby the qualification of such an acquisition as an FDI is generally reserved for interests of ten percent or more. In other words, investment, as used in connection with FDI, may be defined as “general capital outlays from an investor made for the purpose of influencing the business activities of a company abroad in a direct and lasting manner.”<sup>14</sup> At the same time, however, FDI involves more than just the flow of capital; it also brings with it the potential for a transfer of political, economic and technological know-how. In an attempt to encourage large corporations that benefit financially from FDI to assume certain responsibilities towards the LCDs in which they invest, the OECD began publishing in 1976 their “Guidelines for Multinational Enterprises” (most recently revised, for the fifth time, in 2011). The definition used by the OECD – and by the IMF – for enterprises that are involved in FDI is as follows: “Foreign direct investment enterprise is an enterprise (institutional unit) in the financial or non-financial corporate sectors of the economy in which a non-resident investor owns 10 per cent or more of the voting power of an incorporated enterprise or has the equivalent ownership in an enterprise operating under another legal structure.”<sup>15</sup> Once the initial investment has been made, there are various

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<sup>12</sup> Cf. *Peter* (1995), 5.

<sup>13</sup> Foreign Direct Investment in Emerging Market Countries, Report of the Working Group of the Capital Markets Consultative Group, September 2003, 41.

<sup>14</sup> <http://www.seco.admin.ch/themen/00513/00594/04174/index.html?lang=en>

<sup>15</sup> Cf. IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics, Direct Investment Technical Expert Group (DITEG), Issue Paper 20, Definition of Foreign Direct Investment (FDI) Terms, November 2004, Annex I.



ways of increasing the size of a given FDI: injections of further equity capital, reinvestment of a branch or subsidiary's undistributed earnings, extension of credits and loans from the parent company to the subsidiary, etc., all of which are considered forms of additional direct capital investment in the LDC.<sup>16</sup>

At the same time, for the direct investment enterprises, investments by direct investors are only one of the means available for obtaining financing for the expansion of their operations. There is, in principle, nothing to prevent them from seeking loans from unrelated parties elsewhere abroad. Such transactions are no longer qualified as FDI – even if they are guaranteed by the direct investors. Similarly, the term FDI does not apply to all of the assets owned by the direct investment enterprise, but only to that portion that was financed by the direct investor or its affiliates and subsidiaries located in a country other than that of the direct investment enterprise. What counts for the designation of an FDI is neither the nationality nor the citizenship of the direct investor, but the residency.<sup>17</sup> The importance of these distinctions is not to be underestimated, as the implications of being qualified as an FDI, as we shall see, are significant.

### **1. How did the phenomenon of FDI arise?**

Historically, direct investment in foreign countries was an outgrowth of colonialism, a necessary corollary to the appropriation of natural resources by the colonial powers from their colonies in Africa, Asia and South America. In order to supply the raw materials needed for industrializing their own economies, the Western colonizers were obliged to fit out their colonies with the infrastructure needed to facilitate extraction.<sup>18</sup> During this period, “the foreign investors enjoyed almost sovereign rights, a sort of ‘enclave status’ in the host country, without state control or state joint-ownership and only minimal financial

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<sup>16</sup> Foreign Direct Investment in Emerging Market Countries, Report of the Working Group of the Capital Markets Consultative Group, September 2003, 41.

<sup>17</sup> Foreign Direct Investment in Emerging Market Countries, Report of the Working Group of the Capital Markets Consultative Group, September 2003, 41.

<sup>18</sup> Cf. *Sornarajah* (2010), 38.

obligations.”<sup>19</sup> While this situation officially came to end with the movement towards decolonization in the second half of the twentieth century, the West was reluctant to forfeit wholesale all of the prerogatives it had so long enjoyed. As a means of maintaining their advantage over time, the more advanced countries developed a number of legal instruments to protect the investments of their – for the most part privately owned – manufacturing and production industries in such valuable assets as low-cost natural and human resources in the former colonies. These investments were generally enshrined in agreements negotiated between the private investors and the governments of the host countries, and most often included grants of long-term concessions, in particular, for the extraction of oil, minerals, timber, and the like. The ostensible political and macro-economic grounds for the awarding of what were normally highly lucrative contracts at remarkably generous terms was a need to provide investment incentives to Western companies as a means of furthering export-oriented development strategies in the former colonies.<sup>20</sup> The reality behind the granting of such terms in nearly all industries throughout the Third World, it has been remarked, was somewhat different:

“Concession agreements were not confined to the petroleum sector but were utilized in other mineral resources sectors as well. The Ashanti goldfields concession concluded in Ghana provides an example of an agreement to prospect for gold that was to last for 100 years from the date of the agreement. The ruby mines in Myanmar (Burma) were subject to similar concessions. Similar agreements existed throughout the developing world. They were executed in the context of unequal bargaining power, the rulers of the states either not having the power to resist the terms that were imposed on them or not having the expertise or desire to bargain for better terms.”<sup>21</sup>

It is widely conceded that such long-term concessions as were regularly awarded during the period of decolonization were, in the main, highly exploitative and abusive, as they made the development of extensive portions of the publicly owned natural resources of the host countries subordinate to the private interests of foreign companies, and this for considerable

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<sup>19</sup> *Peter* (1995), 6.

<sup>20</sup> Cf. *Vernon* (1966), 190f.

<sup>21</sup> *Sornarajah* (2010), 38.

lengths of time.<sup>22</sup> Throughout the period of the Cold War, attempts to redress some of the imbalances were ideologically tinged. While the investing companies argued the benefits of privatization as the most suitable means for advancing the economic interests of the host countries, many of the LDC, with the support of the Communist bloc countries, asserted their right to nationalize production facilities built through FDI, as a more rapid and direct method of regaining control over their natural resources. With the collapse of the Soviet Union and the realignment of both Russian and Chinese economic policies in the 1980s and 1990s, however, the LDC no longer had sufficient backing to resist Western demands for privatization. In many of the LDCs, the immediate result of the policies imposed upon them was a severe recession, which left them in a paradoxical situation: while their future in the long term required that they improve their control over foreign investments, pressing economic difficulties compelled them, in the short term, to do whatever was necessary to attract additional foreign investments.<sup>23</sup>

## **2. Different forms of investment contracts**

The highly exploitative contracts that bound LDCs to the terms of a concession for inordinate periods of time have, in the meantime, given way, to a certain extent, to more balanced forms of foreign investment agreements. Thus, for example, many FDI projects are now set up as joint ventures between the foreign and local investors, either public or private. In the following, I would like to discuss three of the typical types of legal arrangements currently in use for structuring relations between the multinationals and the host countries for projects such as the extraction of oil or minerals: (a) modern concession agreements; (b) production sharing agreements, and (c) participation agreements and other joint ventures. Each model foresees different degrees of control being accorded to the multinationals, different compensation structures, and different levels of involvement for publicly owned companies in the host countries.

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<sup>22</sup> Cf. below Modern Concession p. 8 and *Smith/Dzienkowski* (1989).

<sup>23</sup> *Peter* (1995), 8.

**a) Modern concession agreements**

Concession agreements involve the contractual grant – by a government to a foreign direct investor – of quasi-sovereign, exclusive rights over a specified geographical area.<sup>24</sup> In return, the concessionaire is required to pay royalties, usually calculated as a percentage of its revenues.<sup>25</sup> This was the type of arrangement that largely characterized the early post-colonial era, and was particularly advantageous to the foreign investors. As Sornarajah notes, “Under the terms of the concessions the contractor held complete autonomy over operations and could even choose not to undertake efforts to exploit the resource without any consequence.”<sup>26</sup> In order to ensure that the terms of such agreements remained unchanged over time, investors often insisted upon the inclusion of a stabilization clause barring the host country from unilaterally amending the agreement or from acting in manner prejudicial to the rights that had been granted to the foreign company.<sup>27</sup> The company, it was argued, assumes the full risk in the event that the concession area proves to be unproductive. Thus, if a company invested in drilling for oil, for example, and no oil was found, the loss was to be borne entirely by the company. The other side of the coin, of course, was that if oil was struck in unanticipated amounts, the company could reap nearly unlimited profits with no obligation to share them with the host country. The amount of any bonus due to the country in the event of such a discovery was fixed in advance in the agreement; beyond that sum, the company paid only the agreed regular royalties, the size of which rarely reflected that of the company’s true earnings.

In many cases the rationale given for the LDCs’ acceptance of the legal and economic hegemony of the multinationals through the concession system was that it provided an opening for the transfer of technology from the industrialized countries to the Third World. However, even where know-how was indeed passed on, investors used their bargaining power to obtain royalties and licensing fees for the access thereto, while at the same time “imposing

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<sup>24</sup> In the early petroleum arrangements the concession periods were extremely long term (fifty to seventy years period). Cf. *Smith/Dzienkowski* (1989), 17.

<sup>25</sup> Cf. *Sornarajah* (2010), 38.

<sup>26</sup> *Jacobs/Paulson* (2008), 370.

<sup>27</sup> *Comeaux/Kinsella* (1994), 3f.

such extensive and long-lasting restraints on the use of the technology that the benefits to the country and its citizens are as minimal as the benefits received under an old-style oil concession.”<sup>28</sup> This situation was typical throughout the entire developing world. The common denominator, as Sornarajah notes, was this:

“The people of the state were seldom beneficiaries of these transactions. These agreements were repugnant from the perspective of democratic notions of sovereignty. Often they were signed by rulers who did not understand the implications of contracts they were concluding or they did not care as, being absolute rulers, they could utilize the royalties they received for their own benefit.”<sup>29</sup>

The terms of international contracts for the exploitation of natural resources (fossil fuels, minerals, and gas) evolved over the course the 20th century, reflecting economic, political and diplomatic changes in the world.<sup>30</sup> Over time, the crass exploitation of native populations for cheap labor, along with other human rights violations by multinational corporations in search of natural resources, came to be looked upon with disfavor by the public. The end of colonialism, and the shifts in world politics that accompanied it, gave rise to a concomitant rise in nationalism in the former colonies. Those nations that were particularly rich in natural resources came to understand that their “oil wealth” or “mineral wealth” gave them considerable bargaining power of their own in dealing with the industrialized world, if put to use effectively.<sup>31</sup> To this end, as Jacobs and Paulson point out, “By the mid-1970s, the majority of the world’s oil producing countries had established government agencies or ministries and national oil companies to manage and operate fields themselves, to implement government energy policies, and to oversee operations by contracting multinational companies.”<sup>32</sup> As a result, although concessions are still in use, they are no longer granted at the same kinds of terms as characterized the early post-colonial agreements. One of the principal differences is that the duration of modern concessions is normally much shorter; in

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<sup>28</sup> *Smith* (1988), 494.

<sup>29</sup> *Sornarajah* (2010), 39.

<sup>30</sup> *Jacobs/Paulson* (2008), 370.

<sup>31</sup> Cf. *Smith* (1992), 493f.

<sup>32</sup> *Jacobs/Paulson* (2008), 371.

addition, they normally require that the concessionaire contribute to a development program in the host country.<sup>33</sup> More commonly, however, concessions have been replaced by production-sharing agreements, the nature of which is substantially different, and whose terms tend to be far less disadvantageous to the host countries.<sup>34</sup>

### **b) Production-Sharing Agreements**

An alternative legal structure, widely in use today for facilitating the exploration and development of natural resources in LDCs with the help of foreign direct investment, is the so-called production-sharing agreement (PSA).<sup>35</sup> Such agreements are designed as a means of bringing more advanced technical and managerial know-how to the host countries while assuring that they still maintain control over their own territory and resources.

Under such contracts, the investor company supplies the technological, financial and organizational resources needed for exploration and production, while the host government contributes the acreage. The parties agree at the outset on the quantity of the resource extracted that each is to receive. The amount is normally calculated in such a way as to ensure that the foreign company is able to recover its costs and earn a reasonable, but specified, profit.<sup>36</sup> The portion of the production to be used for reimbursing the investor's outlays – referred to as the “compensation production” (or “cost oil” in oil contracts) – is normally limited to a maximum of 75 percent of the production.<sup>37</sup> The remainder, known as the “profit

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<sup>33</sup> *Smith* (1988), 494; cf. *Peter* (1995), 211.

<sup>34</sup> *Jacobs/Paulson* (2008), 370: “Depending on the circumstances, such changes include: (1) the host nation retaining title and ownership over the resource; (2) the term of the agreement spanning a far shorter period of time (20–40 years); (3) the grant covering smaller territorial areas; (4) specific monetary commitments being made for exploration and development during early operations with all costs carried by the contractor; (5) a state-owned oil company or ministry being assigned to oversee, or participate in operations with, the contractor; and (6) more generous compensation being paid to the host-country through bonuses, graduated royalty and share levels, and taxes on the contractor's income.”

<sup>35</sup> *Toms/Yaremko/Voytsekhovska/Kvederis* (2011), 121; *Svendsen* (2008), 290: “PSAs are a well-recognised concept and used in more than 40 countries, such as Angola, Vietnam, Libya, Egypt, Malaysia, Peru, Syria, the Philippines, Russia, Azerbaijan, and Kazakhstan.”

<sup>36</sup> *Dzienkowski/Peroni* (1988), 435.

<sup>37</sup> *Svendsen* (2008), 291.

production” is then shared between the investor and the host country.<sup>38</sup> In addition, the host country will normally require that the investing company provide documentary proof that it actually possesses the requisite technology, capital and expertise.<sup>39</sup> As Smith and Dzienkowski note, “The purchase or licensing of privately generated – typically Western – technology is a matter of great importance in the extractive industries. A company’s technology, processes and specially developed formulas are often its most valuable assets.”<sup>40</sup> The long-term objective of the host country in a PSA is, in most cases, to obtain from its multinational partner the technology it needs enable the state oil company to conduct further operations on its own.<sup>41</sup> With this in mind, it is essential that a relationship of trust be established between the government representatives of the host country and the foreign company making the investment.

A major disadvantage for the investing company is that it is normally obliged to bear both the mineral and the financial risk on its own, with no guarantee if the acreage proves to be unproductive.<sup>42</sup> At the same time, however, since the PSAs are designed to attract multinational corporations that will be willing to risk capital and share their technological expertise, the host countries must also furnish some form of reciprocation. Most often, this is done by offering stability – in the form of a contract of long duration – to act as a counterweight in the investor’s risk assessment calculations. Thus, PSAs may be signed for periods of up to 50 years, as compared with the current maximum of 20 to 30 years on oil and gas concessions. Another common feature included in PSA to improve their attractiveness to foreign investors are clauses foreseeing certain tax advantages and the simplification of legal procedures for bringing in foreign employees, and for obtaining the requisite authorizations,

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<sup>38</sup> *Toms/Yaremko/Voytsekhovska/Kvederis* (2011), 122.

<sup>39</sup> *Toms/Yaremko/Voytsekhovska/Kvederis* (2011), 122.

<sup>40</sup> *Smith* (1988), 494.

<sup>41</sup> *Dzienkowski/Peroni* (1988), 436.

<sup>42</sup> *Dzienkowski/Peroni* (1988), 435.

construction permits, and the like, needed in connection with the planned exploration and production activities.<sup>43</sup>

Also of interest, in terms of the increased responsibility of the foreign investors through PSAs, is the inclusion, in many such contracts, of a liability clause rendering the foreign investor strictly liable for any environmental damage resulting from its activities; the investor is generally presumed responsible unless it is able to prove that the damage was caused by natural events or the intentional acts of the victims.<sup>44</sup> Inclusion of such liability clauses illustrates what Jacobs and Paulson refer to as an “evolution in the sophistication of policy implementation in producing countries,” which has “proven critical to defending against claims of environmental damage or mismanagement.”<sup>45</sup>

### **c) Participation Agreements – Joint Ventures**

A more equitable form of FDI, increasingly used today, is that of participation agreements, a type of joint venture in which an foreign company and a state-owned company in the investment country acquire holdings in each other as a means of joining their interests and resources. This is a further step in the evolution of FDI: from the blatantly exploitative concessions in the early period, via production-sharing as a means of according the host countries greater rights, to joint ventures, the terms of which are negotiated between parties of equal standing. The willingness of the foreign companies to accept such terms arose largely as a result of competition between companies with similar products for access to resources and markets. In some cases, the research and development of new products created more specialized needs, making the companies more dependent on specific natural resources. In addition, increasing interest in the host countries as markets, coupled with the often daunting hurdles to access for foreign companies, has made joining forces with local companies in the investment countries increasingly attractive – and profitable for all concerned. While the foreign company is able to supply technical expertise, the local company’s experience with

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<sup>43</sup> *Toms/Yaremko/Voytsekhovska/Kvederis* (2011), 125f.

<sup>44</sup> *Toms/Yaremko/Voytsekhovska/Kvederis* (2011), 125f.

<sup>45</sup> *Jacobs/Paulson* (2008), 371.



the domestic market can prove invaluable in the making of production and distribution decisions.

Participation agreements represent the fairest way to structure FDI. Because they involve the creation of an ongoing collaborative effort between the country or local participant and the multinational corporation, both sides have an interest in maintaining the reciprocity of their relationship.<sup>46</sup> There are two basic forms of participation arrangements currently in use. One possibility is for the parties to form a “jointly owned entity,” a corporation that is responsible for developing the mineral reserves or other natural resources. The alternative is for the parties to simply define the terms of their relationship through a “contractual arrangement,” as a form of partnership. In both cases, the purpose is to allow the local partner to actively participate in developing and producing the mineral reserves.<sup>47</sup> In most cases, the local partner will be a state-owned company, which may have been formed for the very purpose of participating in the joint venture.<sup>48</sup> The foreign multinational supplies technical information and know-how; the local company, which will normally have some form of monopoly position in a given sector, shares the use of its exclusive rights with the new partner. By applying the expertise of the foreign partner to the resources of the local partner, both are able benefit. Costs and profits are shared, and this at a ratio corresponding to the respective equity holdings of those participating in the joint venture.

For the host countries, there are basically two possibilities for setting up joint ventures. The first is where a concession agreement with the foreign investor already exists, in which case it can be renegotiated and converted into a participation agreement. Where there is no prior concession, an entirely new joint-venture agreement can be drafted in such a way as to include opt-in or opt out-clauses. Under such agreements, the foreign investor is given the go-ahead to commence exploration work and, depending on what is found, the government of the

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<sup>46</sup> *Dzienkowski/Peroni* (1988), 450.

<sup>47</sup> *Dzienkowski/Peroni* (1988), 450.

<sup>48</sup> *Peter* (1995), 12: “The development of joint-venture contracts and various types of service contracts was based on the objective of the host country’s increased financial participation and control of the project, which created the need for an organized body counterpart facing the investor.”

host country can choose to take part in the joint venture, or, in the event that the preliminary results are less promising, choose not to. In this way, the host country, which may be lacking in the funds, the technology, or the know-how needed for exploration, increases its opportunities for exploiting its own natural resources. At the same time, for the foreign investor, the exploration work will not normally represent an unreasonable expense or effort in relation to the potential gains. By making their mutual rights and obligations contingent upon the findings of the preliminary exploration activity, both sides are able to mitigate their risks. For such agreements to work, however, it is essential that both parties have confidence in each other's intent to deal in good faith.

### **3. Investment products and their principal markets**

To illustrate the manner in which the different forms investment agreements can play a role, it will be useful now to consider in greater detail the main investment products and markets that attract foreign direct investment.

The main sectors for foreign investment in the LDCs, not including human resources, are those supplying what are referred to as commodities on the world's exchanges: natural resources that serve as raw materials, such as oil, gas, metals and minerals, and unprocessed agricultural products, all of which are plentiful in the LDCs. The present paper will not consider FDI in agricultural commodities, as, historically, the transfer of technology and know-how has not played a central role in the development of those markets.<sup>49</sup> Hence, the main issues involved in that sector relate less to international investment law than to questions concerning practices used in "the trading of coffee, cocoa, grains and the like on the international markets. By contrast, the exploration and mining of mineral ores and the various methods used for extracting and processing the minerals require specific expertise and technology. For this the aid of foreign companies is often essential for the LDCs, making the prospect of FDI in these sectors more interesting – both for the investors (not least, due to the availability of cheap labor) and for the host countries.

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<sup>49</sup> In recent years, the role of technology in the production of agricultural commodities – in particular, where genetically modified organisms are involved – has, to be sure, been greatly expanded. For the purposes of the present remarks, however, consideration will be restricted to the basic non-agricultural resources.

Foreign direct investment in the digging of mineral ores is, still today, largely structured through the use of concession agreements. The actual mining of minerals does not require any special technology: the ore is taken from the ground using either labor-intensive manual methods or chemical techniques. Investors are principally interested in gaining authorization to exploit large areas of land. The construction of mines creates employment locally, which, it is argued, serves to stimulate the overall economy of the host country. For the purpose of the present analysis, the extraction of important minerals such as cobalt and copper will be taken by way of example. The tables below show the principal sources of those minerals, and their total production for the year 2010. As may be seen, the geographic distribution of these minerals is primarily in South America<sup>50</sup> and Africa,<sup>51</sup> where there are huge deposits; Asia, with the exception of China and Indonesia, is not represented among the major sources of metals and minerals.

<b>Metal</b>	<b>Country</b>	<b>Tons in 2010</b>	<b>Metal</b>	<b>Countries</b>	<b>Tons in 2010</b>
<b>Copper</b>	Chile	5'418'900	<b>Cobalt</b>	D.R. Congo	70'000
	China	1'191'200		China	6'500
	Peru	1'247'126		Zambia	5'134
	USA	1'129'300		Australia	4'819
	Indonesia	878'376		Canada	4'568
	Australia	870'000		Russia	2'460
	Zambia	819'159			
	Russia	702'700			
	D.R. Congo	377'900			

Table 1: Production of copper and cobalt<sup>52</sup>

The situation with regard to the mining of copper and cobalt in Africa is typical for the mining also of other metals and minerals in many countries of the Third World. The developing countries of Sub-Saharan Africa have lagged far behind in the process of

<sup>50</sup> P A J Lusty, South America Mineral Production 1997-2006, A Product of the World Mineral Statistics Database, British Geological Survey 2008, 4.

<sup>51</sup> A J Brenam/T J Brown, African Mineral Production 2001-2005, A Product of the World Mineral Statistics Database, British Geological Survey 2007, 4. According to statistics furnished in "African Countries of the Future: Winners 2011/12" the DRC has the fourth largest labor force in Africa, available online at: <<http://www.fdiintelligence.com/Rankings/African-Countries-of-the-Future-2011-12/>>.

<sup>52</sup> T J Brown/A S Walters/ at En Idoine/RA Shaw/ CE Wrighton/T Bide, World Mineral Production 2006-2010, British Geological Survey.

economic and social development known in other parts of the world.<sup>53</sup> In order to come to grips with the daunting tasks of eliminating poverty and providing the prospect of a better life for their growing populations, these countries are dependent upon inflows of capital from abroad, with FDI as the most readily available source. In order to attract such capital, it is customary for these countries to adopt investment codes outlining the conditions for foreign investment. As Ekpombang points out, “The aim of these Codes has been to encourage the orderly exploitation and development of the country’s resources, while ensuring that only those investments that could accelerate the development process are promoted through the provision of investment incentives.” At the same time, because of the need to attract and encourage investors, the codes have been designed to serve as a virtual “honey pot” to foreign investors.<sup>54</sup> The result of these attempts to render foreign investment in their countries sufficiently attractive has been that the investment agreements that come to be signed provide only meager gains for the local populations. Zambia and the Democratic Republic of the Congo are two well-known examples. As pointed out in a study of the commodities industry by the *Declaration of Bern*, “Zambia ought to be being smothered in profits. And yet, it is one of the poorest countries in the world, for which neither war nor a dictatorship provides an explanation.”<sup>55</sup> Similarly, the Congo is known to be the world's richest country in natural resources - including enormous deposits of copper and cobalt. But here, as well, the local population derives no benefit from this wealth.<sup>56</sup>

Turning now to the oil and natural gas industries, it is noticeable that there has been considerably more flexibility in the development of FDI agreements in these sectors than in the mining industry. While concession agreements have not been entirely abandoned, the general tendency is towards production sharing and joint ventures that foresee the sharing of technology in oil and gas production. Exploitation agreements under which the relationship between the investors and the host country is equitably structured, have contributed to

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<sup>53</sup> Eifert/Gelb/Ramachandran (2006), 195.

<sup>54</sup> Ekpombang (2011), 123f.; cf. also Morisset (2000), 3.

<sup>55</sup> *Erklärung von Bern* (2011), 97.

<sup>56</sup> A J Brenam/T J Brown, African Mineral Production 2001-2005, A Product of the World Mineral Statistics Database, British Geological Survey 2007, 4.

economic development in a number of countries. The technology transfers take place in the context of joint ventures, which enable the investment countries to gradually overcome their dependence on FDI and commence drilling and production on their own. Emerging markets such as Russia – the world’s number one producer of natural gas – have, in the meantime, fully understood the strategic and economic importance of their natural resources and of maintaining independent control thereover.<sup>57</sup>

<b>Production of Crude Oil</b>	<b>Countries</b>	<b>Tons in 2010</b>	<b>Production of Natural Gas</b>	<b>Countries</b>	<b>Million cubic meters in 2010</b>
	Russia	505'000'000		Russia	649'000
	Saudi Arabia	467'800'000		USA	611'000
	USA	345'381'255		Canada	151'023
	Iran	203'200'000		Iran	138'500
	China	203'000'000		Norway	106'430
	Mexico	152'670'000		China	96'800
	Canada	141'200'000		Indonesia	93'255
	UAE	130'800'000		Qatar	85'430
	Venezuela	126'600'000		Netherlands	83'944
	Kuwait	122'500'000		Saudi Arabia	83'900
	Iraq	120'400'000		Algeria	80'400
	Nigeria	115'200'000			
	Brazil	110'600'000			
	Norway	104'881'356			

Table 2: Production of crude oil and natural gas<sup>58</sup>

**B. Divergent investment objectives**

Ideally, foreign direct investment should bring benefits to both the host country and the investing entity.<sup>59</sup> There are, however, opposing views as to the extent to which this ideal can actually be realized through the mechanisms of FDI. “Classic” economic theory on FDI tends to emphasize the benefits that accrue to the host countries. The LDCs have much to gain through the outside investments in terms of sustainability, it is argued, since the foreign capital can be used not only to cover short-term needs, but also for creating long-term perspectives – as for example through the creation of employment opportunities. In addition,

<sup>57</sup> P E J Pitfield/T J Brown/N E Idoine, Mineral Information and Statistics for the BRIC Countries 1999-2008, British Geological Survey 2010, p. 36.

<sup>58</sup> T J Brown/A S Walters/ at En Idoine/RA Shaw/ CE Wrighton/T Bide, World Mineral Production 2006-2010, British Geological Survey.

<sup>59</sup> Donovan (2003-04), 5f.

it is posited, the foreign investment projects are normally accompanied by improvements in the host country's infrastructure, including the construction of transportation and sanitation facilities, health and education services, etc. The mechanism at work, as summarized by Sornarajah, is simple: "The foreign investor usually brings with him technology which is not available in the host state, and this leads to the diffusion of technology within the host economy."<sup>60</sup>

Diametrically opposed to this conception is the "dependency theory," which does not see any meaningful economic development coming to the host country through FDI. Rather, it is argued, those financial or other resources that do reach the investment country, normally benefit only the ruling elites, who form easy alliances with foreign capital.<sup>61</sup> Rather than promoting development in the LDCs, foreign direct investment, it is argued, serves only to keep them in a state of permanent dependency. In order for true economic development to come about in the LDCs, according to this theory, it is essential that they overcome their dependency on the developed world. Moreover, in many cases FDI not only fails to promote development, but actually gives rise to new difficulties for the host country. As Peter points out, in addition to disputes over benefits, conflicts "may also be generated by the undesirable side effects of the investment. Environmental and social problems frequently associated with oil and mineral extraction have also become an issue in a number of projects."<sup>62</sup>

A fundamental source of potential conflict in all FDI projects is the divergences between the interests of the parties. This is, of course, also the case in most contractual arrangements; specific to FDI, however, is the inequality of the means available to the parties for asserting those interests. To understand the situation more clearly, it will be useful to consider what the interests of each of the parties involved in an FDI project are, and the risks that such involvement brings with it.

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<sup>60</sup> Sornarajah (2010), 48.

<sup>61</sup> Sornarajah (2010), 53.

<sup>62</sup> Peter (1995), 14.

## **1. Foreign direct investor motivations**

When making an investment decision, the investing entity weighs the potential benefits of the FDI against the potential costs in capital. The determination depends on the assessment of the risks involved, both commercial and non-commercial. In order to ensure the success of the investment, the investor seeks to reduce, or to allocate risk, to the greatest extent possible.<sup>63</sup> Much depends on the nature of the enterprise in question. As Donovan notes, “Manufacturing and service sector businesses have the luxury of calculating the risks with a critical eye, while extractive industries are forced to go to the resources.”<sup>64</sup>

### **a) Interests**

In choosing an FDI, the primary interest of investors, as profit-making entities, is in a lowering of costs. Thus, in addition to access to natural resources, they seek additional favorable terms that can reduce their liabilities. Among the things that host countries have to offer as incentives for attracting foreign investment are lower labor costs, lower transaction costs, and various special privileges reserve for foreign investors, such as tax exemptions.

A further motivation behind FDI in emerging market countries (EMC) is the potential for access to new markets for the investor companies. Here such factors as the size of the market in the host country and its growth prospects can render certain countries more attractive than others for companies seeking new locations for investment. As the Working Group of the Capital Markets Consultative Group reports, investor companies in EMCs are increasingly more interested in servicing local demand than tapping cheap labor resources. EMCs can also serve as export platforms, whereby the productivity of the local labor is, in this connection, of greater significance than the wage level. Also of critical importance for investments in production for export in the EMCs is the availability of a well-functioning infrastructure and the stability of the tax regime, so that costs can be reliably calculated.<sup>65</sup>

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<sup>63</sup> *Donovan (2003-04), 7.*

<sup>64</sup> *Donovan (2003-04), 6.*

<sup>65</sup> Foreign Direct Investment in Emerging Market Countries, Report of the Working Group of the Capital Markets Consultative Group, September 2003, p. 3.

## **b) Risks**

The risks associated with FDI in less developed countries are largely related to the prevailing political conditions. These risks may include such things as corruption, a lack of transparency in the bureaucracy, the arbitrary use of authority, and general political instability. Historically, from the 1950s through the early 1980s, one of the most serious risks was that of expropriation.<sup>66</sup> As Elkins, Guzman and Simmons recall, “The nationalization of British oil assets by Iran in 1951, the expropriation of Liamco’s concessions in Libya in 1955, and the nationalization of the Suez Canal by Egypt a year later served notice of a new militancy on the part of investment hosts. The nationalization of sugar interests by Cuba in the 1960s further undercut assumptions about the security of international investments.”<sup>67</sup> In response to these actions, the UN General Assembly adopted in 1962 the “Resolution on Permanent Sovereignty over Natural Resources,”<sup>68</sup> which foresaw “appropriate” compensation of investors for expropriated assets. It should be kept in mind, however, that such expropriations were often an attempt on the part of the host countries to regain a measure of control over resources that had been wrested from them through clearly abusive concession agreements. While the correction of many of the imbalances through the renegotiation of earlier agreements and the negotiation of more equitable terms in more recent agreements have to a great extent alleviated the risk of nationalization, political risks continue to be a major factor in FDI. As Donovan writes, “Political risks evolve out of government action and affect investment decisions in the target country.”<sup>69</sup>

## **2. Host country motivations**

As mentioned, classic economic theory has largely focused on the benefits that host countries seek from FDI, while supporters of the dependency theory consider primarily the risks. Both

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<sup>66</sup> Donovan (2003-04), 9f.

<sup>67</sup> Elkins/Guzman/Simmons (2006), 813.

<sup>68</sup> 1962 General Assembly Resolution on Permanent Sovereignty over Natural Resources, Adopted by United Nations General Assembly on 14 December 1962.

<sup>69</sup> Donovan (2003-04), 9f.



sides of the argument merit consideration if a host country is to reach a rational decision on any given project.

**a) Interests**

Most countries, whether rich or poor, have an interest in attracting foreign investments. Switzerland, for example, has a policy of granting a wide range of privileges to foreign companies establishing themselves in the country, including unusually generous tax exemptions. A similar tactic of offering tax incentives is employed with remarkable success by the State of Delaware in the United States, making it one of the world's leading venues for letter-box companies. The loss in direct taxes – often exacerbated by the shifting of profits within corporate groups – is compensated for the host countries in other ways. On the one hand, FDI normally creates employment in the investment country, which serves, among other things, as another source of tax revenues. There is usually also an expectation that consumption will rise in the region in which the foreign subsidiary is established, thus contributing to its economic development. In the less developed and emerging markets countries, FDI is also seen as a means of saving on research and development costs through the transfer of technology from the industrialized countries.<sup>70</sup>

In order to judge the extent to which these expectations are realized, increasing attention has been paid in recent years to analyzing the relationship between FDI, exports, and economic growth in host countries. While it is undisputable that FDI brings with it a certain influx of capital and generally contributes to the infrastructures of the host country, the long-term economic benefits are difficult to gauge. This uncertainty has led to a change in the attitude of many investment countries. This was clearly seen, for example, following the East Asian financial crisis in 1997. As Miankhel, Thangavelu and Kalirajan remark, “Due to volatility experienced in the short term capital flows, developing and LDC shifted their focus from attracting short term capital flows to FDI, due to its long term effects.”<sup>71</sup> Most investor countries are interested in FDI only where the commitments on the part of the investor remain in effect over extended periods of time. This, it is hoped, can bring with it a lasting increase in

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<sup>70</sup> Burger (1998), 13.

<sup>71</sup> Miankhel/Thangavelu/Kalirajan (2009), 3.

know-how, improvements in marketing efficiency, experience with new technologies, continuing job growth, and sustained increases in competitiveness and sector efficiencies.<sup>72</sup> These hopes, in the view of Donovan, are, at least to some extent, also realistic: “Indeed, foreign investment can stimulate developing economies and bring about greater stability.”<sup>73</sup>

The flow of foreign direct investments into less developed and emerging market countries varies greatly, both from country to country and over time. In addition, the EMCs – countries such as India, Malaysia, Thailand, Chile, and Mexico – are at different levels of development. This makes comparative studies of the effects of FDI particularly difficult. Moreover, political decisions and events, both expected and unexpected, can also have a major impact on both exports and overall economic growth, making it nearly impossible to judge the contribution of FDI to either.<sup>74</sup> Büthe and Milner argue, based on analyses of 122 developing countries from 1970 to 2000, that by joining international trade agreements such as GATT, WTO, and preferential trade agreements (PTAs), the EMCs and LDCs would be able to attract more FDI.<sup>75</sup> It should be kept in mind, however, that without certainty as to the actual long-term benefits of FDI, it is equally uncertain whether this is something to be desired, or not.

## **b) Risks**

The major risks that FDI brings with it for LDC were described above in connection with the so-called dependency theory. An illustration of the way in which those risks can become reality is provided by the example of Nigeria. In view of the fact that the country is richly endowed with natural resources, and has been a major recipient of FDI, the end result has been highly disappointing. As Ikeanyibe Okey points out, “Rather than being a source of development, unity and peace for the country, the extraction of these resources and the way this has been managed right from the beginning of organised mining, have been a source of

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<sup>72</sup> *Donovan* (2003-04), 5f.

<sup>73</sup> *Donovan* (2003-04), 6.

<sup>74</sup> *Miankhel/Thangavelu/Kalirajan* (2009), 4: “For example, since India and Pakistan are just liberalizing their economies, we should expect the impact on these countries to be different from those of more matured emerging countries of Malaysia and Thailand.”

<sup>75</sup> *Büthe/Milner* (2008), 741.

conflict between the government of the day and various socio-political groups in the country.”<sup>76</sup> High-level corruption and mismanagement of oil wealth are widely seen to have retarded the country’s development. Struggles for control of the resources have given rise to major political conflicts within the country. This has made the country unable to profitably sustain the exploitation of its solid mineral resources. Coupled with the degradation of the environment in connection with extracting and processing those resources, the end result has been that Nigeria’s economic development appears, in reality, to have been impeded by the inflows of foreign capital. As Ikeanyibe Okey writes, “Today, Nigeria imports petroleum products despite her being the 6th country in the world that produces crude oil; she imports cement despite huge deposits of limestone at various locations in the country, imports iron rods despite huge deposits of iron ore, and many more.”<sup>77</sup>

Chowdhury lists five types of abusive or restrictive business practices that “seriously jeopardize the responsible expectations of the recipients in the developing countries”: (1) suppliers of technology, may make cartel-like arrangements between themselves for the allocation of different territories; such arrangements normally also include limitations on production, sales restrictions, and agreements on the terms and conditions of sales, including fixation of prices; (2) bilateral contracts often impose serious restrictions or prohibitions on the use or purchase of competitive technology; (3) restrictions on exports; (4) tie-in arrangements and hidden costs; and (5) prohibition on modifications or further development of the foreign technology.<sup>78</sup>

### **C. Balancing of interests**

The following table summarizes what has been said thus far with regard to the motivations behind and the risks involved in FDI for both the investors and the host countries.

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<sup>76</sup> *Ikeanyibe Okey* (2010), 51.

<sup>77</sup> *Ikeanyibe Okey* (2010), 51.

<sup>78</sup> *Chowdhury* (1987), 266f.

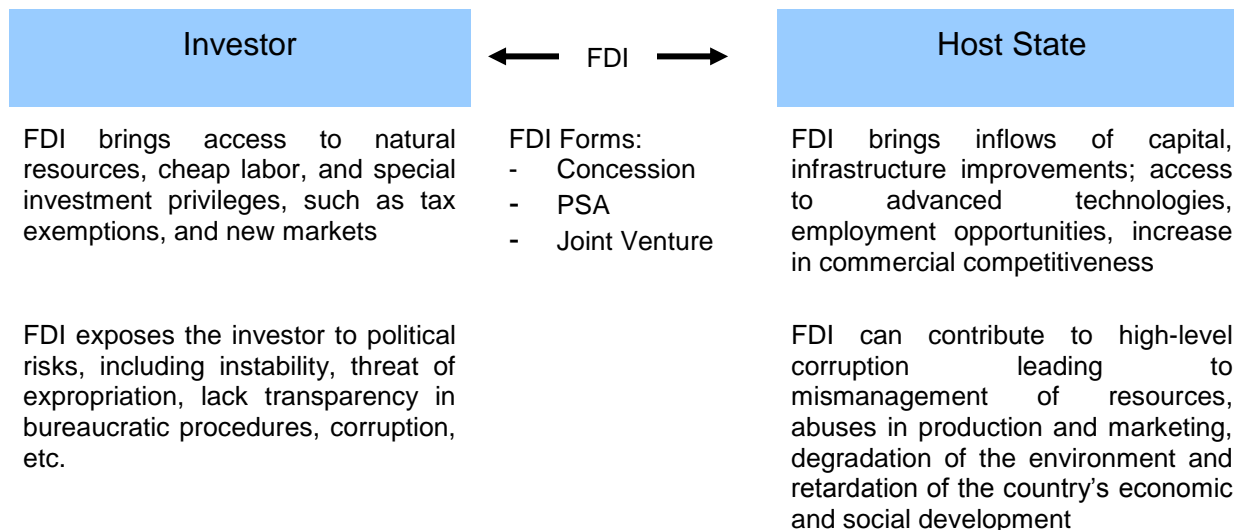


Table 3: Recapitulation of Motivations and Risks of Investors and Host States

The accepted rationale behind FDI is summarized by von Aaken and Lehmann: “The classical theoretical causal chain assumed by treaty makers (and classical economic textbooks) is that International Investment Agreements (IIAs) foster FDI, FDI leads to economic growth, and growth leads to enhanced welfare of the population.” As those same authors point out, however, “By now we know that some of those causal assumptions are empirically fragile or that the assumed causal link works only under certain circumstances.”<sup>79</sup>

Proceeding on the assumption that foreign direct investment is beneficial to all concerned, various international efforts have been made promote FDI by creating instruments for the protection of such investments. These include such multilateral agreements as GATT and GATS, as well as bilateral investment treaties (BITs). At the same time, the WTO, for example, encourages the use of free trade agreements to remove import, export and tax barriers and provide government-backed legal certainty for trading partners. Nevertheless, in the case of politically unstable countries, which are not eligible for membership in the WTO, the protection of foreign investments becomes more problematic. This has given rise to a two-track system, in which those countries deemed eligible may become signatories to multi-lateral agreements, while those that suffer from political instability or are otherwise ineligible for treaty membership rely on BITs to provide the investment protection needed to attract

<sup>79</sup> van Aaken/Lehmann (2011), 4.

foreign capital. The terms of these agreements are often prescribed by the industrialized countries, who demand the inclusion of stabilization clauses and other terms for the protection of investor rights – as, for example, guarantees against expropriation or the right to take legal disputes to independent arbitration courts. In this same vein, it was with the potential threat to foreign investments resulting from political unrest in the LDCs that International Centre for Settlement of Investment Disputes (ICSID) was founded, under the auspices of the World Bank.

Given the often staggering amounts that can be involved in FDI, it is, of course, understandable that efforts would be made to protect those investments. The rationale given is that this is good for both parties, since foreign investors would be loathe to place their capital in LDCs without such protection. At the same time, it is difficult to overlook what would appear to be an imbalance. On the one hand, the potential rewards for such investments are often exponentially higher than the amounts invested. By providing investors with the opportunity to make such high profits at low risk, the various investment protection measures could be said to actually be skewing the market – unless, of course, they were also to provide equivalent benefits to the investment countries, the LDCs. Many observers have expressed serious doubts as to whether this is the case, however. Indeed, the often disastrous consequences of foreign investments in LDCs have become so notorious that countries endowed with rich deposits of natural resources are often said to have been cursed:

“The resource curse is a term used for the paradox that countries with abundant resources face lower economic growth. The explanatory factors abound: the economic factors mentioned are revenue volatility, Dutch disease, and insufficient economic diversification. But the institutional or political economy explanations are even more at the forefront: corruption; no need for taxation, which takes pressure from governments; conflicts about the revenues generated from resources; no development of human capital; violations of human rights.”<sup>80</sup>

If international investment law is seen as having as its goal the promotion of “good

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<sup>80</sup> van Aaken/Lehmann (2011), Fn. 23.

governance”<sup>81</sup> in the flow of capital investments around the world, the logical consequence is that it would also serve to ensure that the conditions governing foreign direct investments are fair to all parties.

Olaya has observed that, “Many of the investor protection mechanisms are perceived also as investment promotion mechanisms, particularly in the developing world, precisely because of the institutional obstacles associated with weak governance.” In other words, rather than aiding in resolving weak governance issues in the LDCs, the investment protection instruments work around them by furnishing the external protection that a properly functioning state would normally be able to offer through its own institutions. Were such institutions to exist in the LDCs, however, it is not at all clear that this would render them more attractive for FDI. As Olaya remarks, “It would be simplistic though, to assume that investment levels respond solely (and flexibly) to institutional changes.”<sup>82</sup>

In the following, I would like to take a closer look at three investment protection mechanisms currently in wide use: bilateral investment treaties, investment arbitration, and investment guarantees. Of particular interest will be the question as to the extent to which they succeed in their objective of overcoming through good governance the spread of corruption and the lack of transparency in FDI.

## **II. Bilateral Investment Treaties**

To begin, it will be useful to take a brief look at the history and evolution of BITs and to consider the ways in which they differ from other trade agreements. In a second step, the triangular relationship involved in BITs (investor – home state – host state) will be analyzed as a factor in the stabilization of FDI. This will provide the basis for a discussion of the effects of BITS, not only from the point of view of the investors but also from that of the less developed investment countries. In addition to considering both the positive and the negative

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<sup>81</sup> Olaya (2010), 2: “Governance is understood here as the manner in which power and authority are acquired, organized and exercised and the way that the relation existing between the authority and those subject to it (or affected by it) takes place.”

<sup>82</sup> Olaya (2010), 4.

aspects of FDI for the LDC, the role of democratic process in the negotiation of BITs will also be examined.

## **A. Definition and evolution of the Bilateral Investment Treaty**

The recognized purpose of bilateral investment treaties is to afford foreign investors with international legal protection from the non-commercial risks that may be associated with investments – such as unlawful expropriation or unjustified restrictions on payments. In the definition given by Deutsch, “BITs are treaties between nations, ‘state parties,’ that set forth standards of conduct for the government of each state party toward investments of persons and companies of the other state party.”<sup>83</sup> BITs are intended to offer a secure framework for what is commonly termed the “fair and equitable treatment of investors” by providing independent legal protection through dispute resolution procedures beyond the jurisdiction of the investment countries. One of the specific purposes of BITs is to ensure compensation of investors for improper direct and indirect expropriations, in the event that the government of the host country retakes possession of the land on which the investment was constructed.

### **1. Historical background to BITs**

The historical development of BITs runs parallel to that of FDI. The dissolution of the colonial empires gave rise to a need not only for new foreign investment mechanisms, but also for a legal regime to govern them. However, as Guzman, in an article entitled “Why LDCs Sign Treaties That Hurt Them,” points out, however, the recognition of the former colonies as independent states posed a potential difficulty for foreign investors: “As former colonies became sovereign states...these newly minted countries were able to voice their own views, and those views became relevant to the formulation of customary international law. As their numbers grew, these states carried greater weight in the international arena, and as they questioned existing international norms...”<sup>84</sup> In order to counter the emphasis on state sovereignty that prevailed in international law, foreign investors lobbied their governments,

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<sup>83</sup> *Deutsch* (2011), 593.

<sup>84</sup> *Guzman* (1998), 646.

with notable success, for the negotiation of bilateral investment treaties that focused instead on foreign investment protection.<sup>85</sup>

BITs were not an entirely new invention of the post-colonial era. A precursor may be seen in the treaties of “Friendship, Commerce and Navigation” (FCNs) concluded by the United States from the eighteenth century onwards to protect American investors in foreign countries.<sup>86</sup> Unlike the BITs, however, the FCNs were not intended solely for the protection of investments – their primary purpose was the promotion of international trade and the improvement of international relations – although they did include a prohibition on expropriation without compensation. The American FCN program began to wind down after the Second World War and was phased out entirely by the mid 1960s.<sup>87</sup> With regard to their main objective, the FCN’s had been made superfluous by the rise of the General Agreement on Tariffs and Trade (GATT), the purpose of which, as set forth in the preamble, is to furnish “reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce.”<sup>88</sup> Because the protection of investments was an issue not covered by GATT, another solution was sought.

## **2. BITs: State protection of private investments – a triangular relationship**

Bilateral Investment Treaties (BIT) are agreements between states designed to provide a legal and political framework for the protection of private investments in developing countries. By means of international investment protection agreements, so the rationale, cross-border economic activity is to be accorded the benefit of government patronage and protection, in the expectation that this will encourage and sustain economic development, and hence the overall

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<sup>85</sup> Cf. *Sornarajah* (2010), 19f.

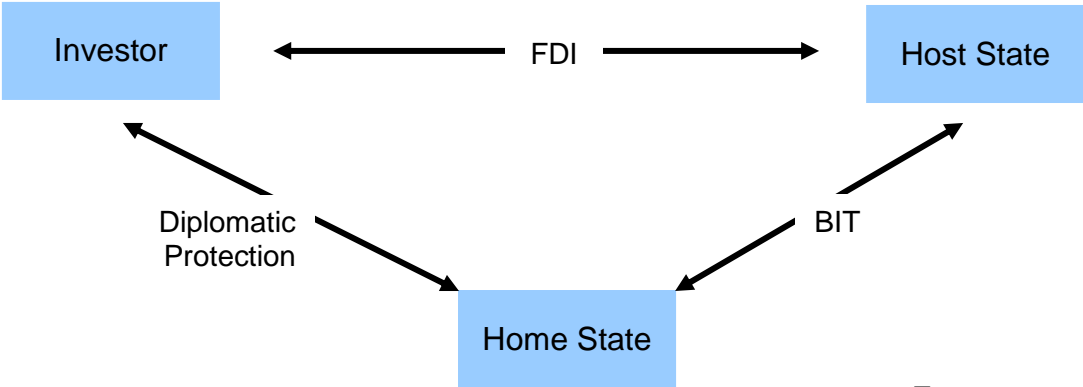
<sup>86</sup> Cf. *Guzman* (1998), 653; *Sornarajah* (2010), 180.

<sup>87</sup> *Guzman* (1998), 652f.

<sup>88</sup> General Agreement on Tariffs and Trade, came into force on 1<sup>st</sup> January 1948, cf. Preamble p. 1.



well-being of the populations of the investment countries.<sup>89</sup> The investment protection provided by the BITs takes the form, among other things, of umbrella clauses, which grant investors privileges that can be asserted as rights under international law – under the doctrine of *pacta sunt servanda* – in disputes with host countries.<sup>90</sup> In justification thereof, it is explained that investor protection is not, in fact, the ultimate purpose of the BITs; rather, as instrument for reconciling international commercial law with respect for international sovereignty, their objective is to contribute to the creation of employment both in the investor’s home country and in the investment country by providing support for multinational enterprises (MNEs) investing in emerging market and less developed countries.<sup>91</sup>



From KRAJEWSKI<sup>92</sup>

BITs represent more than simply bilateral agreements under international law between the investor country and the investment country, since they also have direct effects on the individual investment agreements that detail the terms of each investment project, and which are concluded between the private investors and the host countries. Implicit in such agreements is the ability of the investor to rely on the relationship between its government

<sup>89</sup> Cf. Lemmerz (2010)ff., 224: “In Fortentwicklung der FCN-Gedanken sollen heutige BITs reziprok Direktinvestitionen von Unternehmen des einen Vertragsstaates in den jeweils anderen Vertragsstaat durch ihren Schutzzumfang stimulieren und fördern.”

<sup>90</sup> Krajewski (2009), at 641.

<sup>91</sup> Lemmerz (2010), 224f.

<sup>92</sup> Krajewski (2009), at 538, Figure 6: “Durch diese Sonderbeziehung wird das zwischenstaatliche Verhältnis um eine Dimension ergänzt, die das Welthandelrecht nicht kennt. Das internationale Investitionsschutzrecht ist insofern durch das Dreiecksverhältnis Heimatstaat-Investor-Gaststaat gekennzeichnet.”

and that of the host country and on the willingness of its government to provide diplomatic protection where needed. It is worth recalling that the legal status of the BITs (as agreements between sovereign states) differs from that of the actual investment agreements (as contracts between the investor and the host country). The legal categorization of investment agreements is subject to controversy in the literature due to fact that the standing of a sovereign state – the host country – and that of a private undertaking – the investor – are rendered equivalent under international law by the BITs.<sup>93</sup> Under certain circumstances, it is possible that the agreement between the investor and the host country will be considered only partially valid under international law, as, for example, where it includes a stability clause under which the host country promises not to amend its national laws in a manner prejudicial to the investor, or where an internationalization clause stipulates that the parties have expressly chosen to make the agreement subject to international law rather than to the host country’s own law.<sup>94</sup>

The contractual networks created by these bilateral investment protection agreements can be visualized as a kind of web spun over the entire world, in which each country is connected to the others by countless individual BITs. The BITs, as an outgrowth of what Teubner and Fischer-Lescano have dubbed “polycentric globalization,”<sup>95</sup> give rise to a global regime of investment protection law. To the horizontally coordinated foundational structure of international treaty law is thus added an element of vertical cooperation, through which the private stakeholders are integrated into the triangular relationship between the investor country, the investment country, and the investor.<sup>96</sup> International understanding is achieved by means of cognitive expectations at a transnational meta-level. This contractual network is comprised of multiple structurally independent legal systems. By linking them together,

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<sup>93</sup> Markert (2010), 34f.

<sup>94</sup> Cf. Krajewski (2009), at 579 and at 538, Figure 6.

<sup>95</sup> Teubner/Fischer-Lescano (2007)ff.

<sup>96</sup> Cf. Diehl (2008)ff.

through both multilateral and bilateral agreements, it seeks to encourage sustainable international investment.<sup>97</sup>

## **B. Objectives and Effects of BITs**

BITs are designed to protect investors in the event that the government of a host country acts in breach of international law. In theory, the terms of each treaty are the result of negotiations between the governments of the two countries involved. The intent is to ensure that the norms of international law will apply to any investment activities on the part of the investing companies, and that the latter are not subjected to any discriminatory practices.<sup>98</sup> In addition, the BITs normally contain a set of investment policy norms that seek to guarantee transparency concerning the investments. These norms generally correspond to those adopted by the major international economic organizations, such as the WTO, OECD and UNCTAD, in multilateral agreements such as GATT (General Agreement on Tariffs and Trade), GATS (General Agreement on Trade in Services), and TRIMS (Agreement on Trade-Related Investment Measures).<sup>99</sup>

### **1. BITs in LDC: risks and benefits**

The question of whether an increasing number of BITs are being signed simply for political reasons or whether they actually help to remove important economic obstacles was investigated by Egger and Pfaffermayr. They conclude that bilateral investment treaties do, in fact, reduce barriers to FDI, estimating that “BITs exert a positive and significant effect on real stocks of outward FDI, with a lower bound of 15%.”<sup>100</sup> This suggests that despite their inadequacies, the bottom line is that both parties have a real economic interest in concluding BITs – even if the gains are not equally distributed.

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<sup>97</sup> *Amstutz* (2011b): “The emergence of the network contract may be viewed as a chance for developing new legislative tools in the area of European private law in order to come to terms with modern forms of private governance.”

<sup>98</sup> <http://www.seco.admin.ch/themen/00513/00594/04174/index.html?lang=en>

<sup>99</sup> <http://www.seco.admin.ch/themen/00513/00594/04174/index.html?lang=en>

<sup>100</sup> *Egger/Pfaffermayr* (2004), 801.

In order to properly understand the willingness of the LDCs to enter into agreements that are clearly weighted against them, it is necessary to consider what is at stake for the poorer countries. Even if rich in resources, they often lack both the financial and technical means to derive any benefit therefrom without assistance from the outside. At the same time, the number of multinational companies prepared to provide such assistance can often be extremely limited. In negotiations with such potential investors, the interests of the latter are quite clear: they exist to make profits, and hope to do so by expanding their production and reducing their costs, that is, by taking maximum advantage of the resources, both natural and human, available in the host country.<sup>101</sup> For this, they pose conditions, and where those conditions are not met, they can simply seek an alternative investment elsewhere; their continued well-being rarely depends on a single investment agreement. For the host countries, by contrast, there are often no alternatives available.

One of the conditions often demanded is the existence of a BIT between the home country of the investor and the country in which it is considering making the investment. The willingness of the home countries to conclude such agreements is not difficult to comprehend. It is in their obvious interest to create instruments for protecting existing overseas capital and for promoting additional profitable investments.<sup>102</sup> The willingness of the host countries to enter into such agreements has another basis. In competition with other LDCs for foreign capital, each country attempts to increase its attractiveness by the means available – even if this includes becoming party to an unequal contract. In other words, as van Harten points out, many countries “might have decided to conclude investment treaties – however unequal in fact or in law – because they perceived other benefits of doing so (or other risks of not doing so).”<sup>103</sup> Guzman argues that LDCs are confronted by a situation similar to the well-known “prisoner's dilemma,” in which their optimal choice, as a group, would be to reject demands that they be party to such agreements, “but in which each individual LDC is better off ‘defecting’ from the group by signing a BIT that gives it an advantage over other LDCs in the

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<sup>101</sup> Cf. Guzman (1998), 660.

<sup>102</sup> Elkins/Guzman/Simmons (2006), 833f.

<sup>103</sup> van Harten (2010), 45.

competition to attract foreign investors.”<sup>104</sup> As van Harten argues, this competition is further exacerbated by the BITs themselves. Thus, he points out that, “many of the treaties take a liberal approach to forum-shopping. Put differently, they allow owners of assets to pick and choose among nationalities at their convenience for the purpose of bringing investment treaty claims against countries in which they own assets.”<sup>105</sup>

The competitive advantage offered by BITs is described by Guzman: “Consider first the incentives facing an individual developing country. In its negotiations with investors, the country would like to have the ability to make binding commitments to potential investors. If it is able to make credible commitments, it will be able to attract more investors.”<sup>106</sup> To achieve this credibility, the LDCs must overcome the widespread belief that corruption is endemic to the poorer countries of the world. One means of doing so is to enter into BITs, at the price of accepting a certain loss of sovereignty. As Elkins, Guzman and Simmons note, “The more corrupt a state is perceived to be, the more necessary it becomes to lure investors with an explicit promise to delegate adjudication to an authoritative third party.”<sup>107</sup> By using BITs as a means of circumventing local corruption, however, the governments of these countries also escape the need to address the problem of corruption at the root level. For the investors, the residual risks of this corruption – largely mitigated by the BITs – are no longer of great significance in proportion to the potential benefits to be reaped.

## **2. BITs in emerging markets: trends**

Hallward-Driemeier has argued that belief in the effectiveness of BITs for attracting foreign capital is exaggerated. “Clearly,” she writes, “a BIT is not a necessary condition to receive FDI. There are many source-host pairs with substantial FDI that do not have a BIT.”<sup>108</sup> The examples she adduces can be presented in tabular form:

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<sup>104</sup> Guzman (1998), 666f.

<sup>105</sup> van Harten (2010), 28

<sup>106</sup> Guzman (1998), 669.

<sup>107</sup> Elkins/Guzman/Simmons (2006), 834f.

<sup>108</sup> Hallward-Driemeier (2003), 9.

Source-host pairs with substantial FDI that do not have a BIT	Countries that have concluded many BITs and have received only moderate inflows:
<ul style="list-style-type: none"> <li>- Japan – numerous countries: Japan, as the second largest source of FDI has concluded only 4 BITs.</li> <li>- US-China: the US does not have a BIT with China, its largest developing country destination.</li> <li>- Brazil – numerous countries: Brazil, as one of the top receivers of FDI has not ratified a single BIT.</li> </ul>	<ul style="list-style-type: none"> <li>- Sub-Saharan Africa: despite numerous agreements for the protection of investor interests, many countries in Sub-Saharan Africa continue to have difficulties attracting foreign capital.</li> <li>- Cuba-Canada and Cuba-Mexico: Cuba does not have a BIT with either of its two most important foreign investors, Canada and Mexico; by contrast, almost 60% of the countries with which it does have a BIT actually have no foreign investment in Cuba.</li> </ul>

Table 4: BIT Trends

Emerging market countries, in particular, the so-called BRICS countries (Brazil, Russia, India, China, and South Africa), tend to be more reticent about entering into BITs. China and Brazil are good examples: China has no bilateral trade agreement with the US; Brazil has not entered into any BITs whatsoever. As Bellak and Küblböck, observe, this is also a question of bargaining power: strong governments in countries whose economies are particularly attractive to foreign investors have far more room to maneuver in dealing with them and their home countries.<sup>109</sup> One of the principal arguments for Brazil’s reluctance to enter into BITs is based on the question of legal uncertainty. There appears to be some question as to whether the ratification of such agreements is possible under Brazilian law, since their terms may constitute a violation of Brazilian sovereignty. Despite arguments that Brazil had, in the past, routinely entered into agreements that bound it to accept foreign arbitration for the resolution of disputes, Brazil continues to avoid BITs.<sup>110</sup> Whatever the legal arguments, it seems safe to assume that the underlying foundation of Brazil’s stance resides in an awareness of the attractiveness of its resources for foreign investors – which has no need for further embellishment through BITs. As Elkins, Guzmán and Simmons recall, “Brazil did not sign a

<sup>109</sup> Bellak/Küblböck (2004), 28.

<sup>110</sup> Cf. <<http://www.iisd.org/itn/2008/11/30/investment-arbitration-in-brazil-yes-or-no/>>

BIT until 1994, and as of the late 1990s none of its 10 bilateral agreements had entered into force.”<sup>111</sup> This combination of immense wealth in natural resources and a government determined to resolutely protect the country’s sovereignty is a feature common to all of the BRICS countries.

### **3. Improving on BITs: linking stakeholder interests in a win-win situation**

Although both BITs and the agreements between foreign investors and host countries (concessions, production-sharing agreements and equity participation agreements) are focused primarily on the protection of investors, they are nevertheless legal instruments that foresee not only rights, but also obligations on the part of the investors vis-à-vis the host country and other stakeholders. A certain level of awareness in this regard may be seen in the fact that despite the near total absence of provisions concerning sustainability or corporate social responsibility (CSR) in the BITs,<sup>112</sup> the multinational corporations that undertake foreign investment have shown a marked inclination towards voluntarily respecting sustainability and CSR standards.<sup>113</sup> In order to perpetuate this tendency, many observers would like to see social and environmental obligations made legally binding upon investors through the BITs (by including, for example, ILO or sustainability standards). In this way, relations between investors and the host countries could perhaps reflect a more equitable “balance between rights and responsibilities.”<sup>114</sup>

A movement in this direction is also recognizable in the increased role assigned to CSR standards in the extended investor-stakeholder relationship – as illustrated, for example, by the inclusion in the OECD’s Declaration and Decisions on International Investment of a

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<sup>111</sup> *Elkins/Guzman/Simmons* (2006), Fn. 16.

<sup>112</sup> Another term, often used synonymously with Corporate Social Responsibility (CSR) is “Corporate Citizenship,” as found, e.g., in certain codes of conduct by international organizations, such as the UN Global Compact and the OECD Guidelines for Multinational Enterprises, ISO-2600f.

<sup>113</sup> *Lambooy* (2011)ff., 284: „The Law of the Future will probably develop in such a way that BITs include CSR elements. (...) For example, South Africa, Canada and the US have developed or are in the process of developing a BIT model that includes some CSR values. However, BITs will still remain an investment law framework with a primary focus on protecting the interests of home state business organisations.“

<sup>114</sup> *Bellak/Küblböck* (2004), 27.

recommendation for the application of the OECD Guidelines for Multinational Enterprises.<sup>115</sup> Another step was taken with the adoption of the Equator Principles,<sup>116</sup> under which a number of the world's major banks have pledged to ensure that the project financing is made contingent upon the borrower's voluntarily commitment to maintain compliance with environmental and social welfare standards. Similarly useful, from the point of view of the host countries, would the be inclusion in BITs of a requirement that private investors maintain compliance with legally binding sustainability standards – that is, that CSR be made compulsory – in all three areas of contention: the social (respect for human rights), the economic (respect for free market principles), and the ecological (respect for the environment and protection of natural resources). In this way, by their inclusion in the BITs – in the form of “fair and equitable treatment” clauses calling for good governance in the broadest sense – voluntary standards and principles of conduct can find their way into the realm of hard international law.<sup>117</sup> The authority vested in the EU for the harmonization of European laws governing foreign direct investments (TFEU arts. 206, 207), provides a further means for introducing the notion of sustainability into global investment law.<sup>118</sup> Taken together, normative expectations of compliance with sustainability standards, as have already begun to find expression in international agreements, contribute to the gradual creation of an interdependence between investment objectives and social and environmental concerns.<sup>119</sup>

The triangular relationship between the investor's home country, the host country, and the investor results from a combination of bilateral relationships: between the investing company and its home country, between the home country and the host country, and between the

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<sup>115</sup> The OECD Declaration and Decisions on International Investment and Multinational Enterprises, 27 June 2000, declare that they jointly recommend to multinational enterprises operating in or from their territories the observance of the Guidelines for Multinational Enterprises.

<sup>116</sup> Die Equator Principles is a credit risk management framework for determining, assessing and managing environmental and social risk in Project Finance transactions. Project Finance is the common term for the funding for development and construction of major infrastructure and industrial projects. Cf. <<http://www.equator-principles.com/>>.

<sup>117</sup> Cf. *Grubenmann* (2010), 19.

<sup>118</sup> Cf. *Gehne* (2010)ff.

<sup>119</sup> *Gehne* (2010), 285.



investor and the host country. In this sense, the three parties are joined together in what may be termed a contractual network, as described by Amstutz: “Through contractual linkages, bilateral legal relationships – reciprocal promissory agreements – give rise to new orders of expectations, in which numerous actors selectively interacting with each other may be implicated.”<sup>120</sup>

Among those implicated in the contractual networks created through BITs and FDI are the stakeholders affected by the execution of those agreements. The investment contract between the investor and the host country, for example, leads to the creation of new jobs, creating a need for employment and supply contracts directly with the local workers and firms. This directly influences the entire socio-economic environment in the host country.<sup>121</sup> In view of this situation, it is fully consistent with the nature of the legal interrelationships that the role of stakeholders also be formally recognized in the creation of those relations. This is made possible by the inclusion of CSR expectations in the BITs and investment agreements, so that the triangular relationship that has hitherto typified FDI is expanded to include a fourth element: home country – host country– investor – stakeholders. By operating as a closed system this expanded network can then develop further, autopoietically.<sup>122</sup> As a brief illustration, from a CSR perspective, the rights of local stakeholders to file civil suits against foreign investors are severely limited under the FDI arrangements.<sup>123</sup> At the same time, local stakeholders are also denied access to independent arbitration courts, as the conditions for

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<sup>120</sup> Amstutz (2006), 105: “*Vertragsverbindungen lassen aus bilateralen Rechtsbeziehungen – aus zweiseitigen schuldrechtlichen Verträgen – neue Erwartungsordnungen entstehen, in die mehrere, zuweilen zahlreiche selektiv miteinander interagierende Akteure eingebunden sind.*”

<sup>121</sup> John Ruggie, Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, Guiding Principles on Business and Human Rights: Implementing the United Nations „Protect, Respect and Remedy“ Framework, 21 March 2011, Cf., in particular, Principles 4 and 9.

<sup>122</sup> Teubner (2000), 400: “I shall make a strictly anti-individualistic, strictly anti-economic argument for the many autonomies of private law in which contract appears no longer merely as an economic exchange relation between persons but as a space of compatibility between different discursive projects, different contracting worlds.”

<sup>123</sup> Lambooy (2011), 284: “As can be concluded from the current BIT cases [...] BITs presently do not offer the right approach as an international legal framework that can direct MNCs towards CSR, nor can [the stakeholders] become a party to such treaties.”

appealing to such courts are defined in the investment agreements between the investors and the host countries, and apply only to those parties. The host countries, however, normally have a constitutional obligation to safeguard the fundamental rights of their citizens. In that sense it could be argued that there exists not only a social interest but also a legal obligation to include CSR considerations in the legal arrangements for FDI.

### **III. ICSID Arbitration**

The International Centre for the Settlement of Investment Disputes (ICSID) was established in the early post-colonial period for the purpose of strengthening confidence in FDI, primarily by offering independent conciliation and arbitration facilities, as foreseen in the ICSID convention.<sup>124</sup> While it is true that ICSID and other such institutions help guarantee the independence of arbitration awards and thus provide a certain level of security for foreign direct investors, the ultimate impact of such arbitration courts on the LDCs has been the object of much criticism. In particular, the question of political bias in investment arbitration has been raised, giving rise to doubts as to the democratic legitimacy of the procedure. Authors such as Gus Van Harten and Susan Franck have also pointed to a growing disparity in the procedural treatment of the parties to arbitration. After reviewing the various arguments, I will also consider below a more positive role that arbitration can potentially play as a new mechanism in globalizing the enforcement of private law.

#### **A. Investment arbitration: a stabilization instrument for investors**

The BITs foresee different dispute resolution mechanisms for disputes between countries – over the interpretation and application of the BITs – and disputes between investors and host countries – over issues relating to specific investment projects.<sup>125</sup> Disputes between countries are normally settled politically, so that the mechanisms foreseen in the BITs rarely come into use. Disputes between foreign investors and host countries, by contrast, are relatively common. Because many foreign investors lack confidence in the ability of the local courts in

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<sup>124</sup> Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, 18<sup>th</sup> march 1965.

<sup>125</sup> <http://www.seco.admin.ch/themen/00513/00594/04450/index.html?lang=en>

host countries to deal with such disputes satisfactorily, a need was felt early on for an alternative mechanism. It was with this in mind that ICSID Convention was drafted, at the initiative of the World Bank, to encourage further FDI as a means of achieving more rapid economic development in the LCDs.<sup>126</sup> Accordingly, BITs normally contain a provision allowing investors to opt for arbitration under the ICSID Convention where disputes arise, rather than litigating them in the local courts.<sup>127</sup> Investment arbitration thus supplements the BITs as an instrument for stabilizing FDI.

### **1. ICSID-Arbitration and the ICSID Convention**

The BITs provide a legal framework for the settlement of disputes arising out of investment agreements, taking as their point of departure the procedures for judicial settlement, arbitration, and conciliation foreseen in Article 66 (a) of the Vienna Convention on the Law of Treaties.<sup>128</sup> In the FDI agreements between investors and host countries it is usual to include so-called “fork-in-the-road” provisions, which stipulate that the parties may choose at an early stage in a given dispute, between submitting it for adjudication by the domestic courts of the host country, or to seeking independent arbitration – but that they must then abide by that choice.<sup>129</sup> With regard to the specifics of dispute resolution by conciliation or arbitration, the agreements typically provide for a choice: the parties may opt for *ad hoc* arbitration, in which case the rules to be applied will be stipulated in the agreement, e.g., the UNCITRAL arbitration rules;<sup>130</sup> or they may submit the dispute to arbitration under the auspices of an institution such as the International Chamber of Commerce (ICC) or ICSID.<sup>131</sup> The institutionalization of arbitration proceedings is intended to provide the arbitrators with a practical infrastructure and set procedures so as to assure the independence and neutrality of their awards. International arbitration also has other advantages, besides being independent of

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<sup>126</sup> *van Aaken/Lehmann* (2011), 2.

<sup>127</sup> Cf. *Deutsch* (2011), 594.

<sup>128</sup> Vienna Convention on the Law of Treaties, done at Vienna on 23 May 1969, entered into force on 27 January 1980.

<sup>129</sup> *Krajewski* (2009), at 666.

<sup>130</sup> United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules (as revised in 2010).

<sup>131</sup> *Krajewski* (2009), at 538; *Hanessian/Newman* (2009), 246.

national judicial institutions: it is normally quite rapid, and the confidentiality of proceedings is given highest priority. In resolving the dispute, it is, in principle, the national law chosen by the parties that finds application. Increasingly, however, recourse is taken to transnational “soft law” in order to avoid any prejudice to the rights of the adverse party through unforeseen amendments to the law, in particular where the choice of the parties was for the law of the host country. The legal reasoning, as van Harten notes, derives from a “basic principle of international law,” namely, “that a state cannot rely on its own law and governing structure to evade an international obligation.”<sup>132</sup>

The ICSID Convention<sup>133</sup> – sometimes referred to as the Washington Convention, to distinguish it from the so-called New York Convention on the enforcement of foreign arbitral awards<sup>134</sup> – is a multilateral international convention that has thus far been ratified by 144 countries. Unlike the BITs and investment protection laws, it contains no substantive provisions for the protection of investments, but covers only institutional and procedural aspects of investment arbitration.<sup>135</sup> Investors may assert their rights directly against the host country and do not require diplomatic protection or support from their home countries, which could be difficult to obtain in cases where relations between the home country and the host country are sensitive.<sup>136</sup> In addition to the ICSID, which was created specifically for dealing with investment disputes, other arbitration courts are also available, such as the Permanent Court of Arbitration (PCA) in The Hague, the Stockholm Chamber of Commerce (SCC), the

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<sup>132</sup> *van Harten* (2007), 66; The Vienna Convention on the Law of Treaties, done at Vienna on 23 May 1969, entered into force on 27 January 1980.

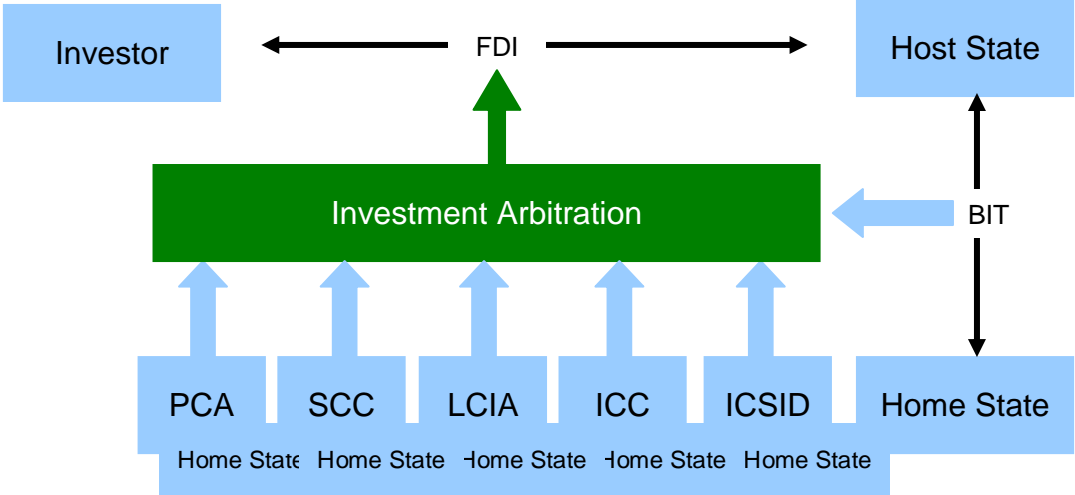
<sup>133</sup> ICSID convention, Regulations and Rules, Convention on the settlement of investment disputes between states and nationals of other states, 10, April 2006.

<sup>134</sup> The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention, done at New York on 10 June 1958, entered into force on 7 June 1959.

<sup>135</sup> *Markert* (2010), 39.

<sup>136</sup> *Krajewski* (2009), N 653.

London Court of International Arbitration (LCIA) or the International Chamber of Commerce (ICC) in Paris.<sup>137</sup>



**2. Global enforcement and its recalcitrants**

The distinctive feature of ICSID proceedings is that they are not subject to any national procedural rules. The parties can rely on the fact that the arbitration proceedings will not be subordinated to any national court proceedings, so that their autonomy is fully guaranteed. In ICSID arbitration, the investors and the host countries oppose each other as equals, that is, the host country has the same standing as a civil party and can, accordingly, be compelled to execute the award. Awards are binding on the parties and are not subject to any appeals in the national courts. The automatic recognition and enforceability of awards is foreseen in articles 53 to 55 of the ICSID Convention,<sup>138</sup> under which the signatories undertake to deploy the authorities responsible for enforcing the execution of judgments in their countries for enforcing the execution of international arbitration awards. There is hardly another

<sup>137</sup> Cf. *Alcabas* (2003), <[http://www.minefi.gouv.fr/notes\\_bleues/nbb/nbb256/256\\_cir.htm](http://www.minefi.gouv.fr/notes_bleues/nbb/nbb256/256_cir.htm)>. See also *Bühler/Webster* (2005), 1-28. A further consideration is noted in *Teubner/Fischer-Lescano* (2007), 37: “Eine geradezu explosionsartige Vervielfältigung voneinander unabhängiger global agierender und zugleich sektoriell begrenzter Gerichte, Quasi-Gerichte und anderer Konfliktlösungsinstanzen ist derzeit zu beobachten.”

<sup>138</sup> Convention on the Settlement of Investment Disputes between States and Nationals of other States, done at Washington on 18 March 1965. The Convention entered into force on October 14, 1966, upon ratification by 20 countries. As of April 10, 2006, there were some 143 Contracting States that had ratified the convention.

international agreement that illustrates the notion of “world law” better than the New York and Washington Conventions. The efficiency of the system is grounded in the global enforcement mechanism foreseen in art. 54, para. 1 of the Washington Convention:

“Each Contracting State shall recognize an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State. A Contracting State with a federal constitution may enforce such an award in or through its federal courts and may provide that such courts shall treat the award as if it were a final judgment of the courts of a constituent state.”

This creates, in effect, a form of globalized supranational judicial order, in the sense that the cognitive expectations created by supranational treaty law are reconstrued and elaborated on through their implication in a global network. The possibility of enforcing arbitration awards worldwide, both in purely civil commercial matters and in foreign direct investment (in which one of the parties is a sovereign state) opens the way to global recognition of transnational bodies of norms, such as the *lex mercatoria*, as constituting public law. The essential point is made by van Harten: “Unlike international commercial arbitration based on rules of *lex mercatoria*, the system of investor protection does not resolve private disputes or regulate the conduct of private parties. Rather, the purpose of the system is to limit how governments regulate multinational enterprises. For this reason, an investor-state dispute pursuant to a treaty is an inherently public dispute; one that involves the exercise of the sovereign power to regulate individuals within a state's territory.”<sup>139</sup>

That said, the reality is that not all arbitration awards are simply enforced without further ado. The dispute between the CMS Gas Transmission Company and the Argentine Republic is a case in point.<sup>140</sup> Rejecting the award handed down by the ICSID, Argentina challenged its validity with a request for annulment filed with the Secretary-General of the ICSID on September 8, 2005. Argentina put forward two principal arguments. The first relied on a fundamental principle of the Argentine constitution, according to which all international treaties are subordinated to the national constitution. In consequence, it was argued, any

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<sup>139</sup> van Harten (2005), 604.

<sup>140</sup> See CMS Gas Transmission Co. v. Argentine Republic, ICSID No. ARB/01/8, 44 I.L.M. 1205 (2005).

ICSID award would have to be reviewed for its compatibility with domestic public policy. The second, more “radical” argument, was that Argentina was not a valid signatory to the ICSID Convention, as the requirements for such signatures, as imposed by the country’s new system for the ratification of treaties, passed by the Argentine National Congress in 1994, had not been satisfied. Had this latter argument been accepted, all claims before the ICSID involving Argentina would have had to be annulled. In the event, the ICSID annulment committee rejected Argentina’s arguments and upheld the award.<sup>141</sup> At present, Argentina nevertheless continues to refuse execution.

While this and similar cases involving Argentina have somewhat shaken the confidence of foreign investors in the international enforceability of arbitration awards, ICSID arbitration is, on the whole, still the solution of preference in disputes between foreign investors and host countries. The awards pronounced by ICSID are recognized as enforceable in most LCDs, and the possibility of taking recourse to arbitration is an important factor in stabilizing FDI.

## **B. Political aspects of ICSID arbitration: democratic legitimacy**

ICSID arbitration is intended to guarantee the impartiality of awards by providing a means of resolving disputes without relying on the national law of the host countries. The need for such independence stems from the notion that foreign investors cannot expect fair treatment in litigation against the government of a host country, where that government appears as a party in proceedings before its own courts.<sup>142</sup> And there is little doubt that international arbitration is a useful means for building trust in the constitutionalization of investment protection law.<sup>143</sup> The closely knit international network of BITs is certainly effective in stabilizing the

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<sup>141</sup> CMS Gas Transmission Company v. Argentine Republic (ICSID Case No. ARB/01/8) (Annulment Proceeding), Decision of the Ad Hoc Committee on the Application for Annulment of The Argentine Republic, September 25, 2007; cf. Samra (2007), 695.

<sup>142</sup> *Wälde* (2010)ff., 313: “[...] domestic courts can rely on the support of their country’s judicial system; in investment disputes, international tribunals as a rule can in practice not refer misconduct by a respondent state to the courts and prosecutors of this very state. That difference means that international investment tribunals have a heightened responsibility to deal with risks to the integrity of the arbitral process themselves and can not offload such responsibility to others.”

<sup>143</sup> *Diehl* (2008), 10f.

expectations of investors, thanks, in particular, to the global enforceability clauses of the Washington Convention. In this case, the international arbitration courts can be also be said to take precedence over national or even international courts,<sup>144</sup> which raises questions as to how a better balance can be achieved between the private interests of investors and the public interest of the host countries where foreign direct investment is concerned. The implications of arbitration awards being made, in effect, over the heads of the sovereign institutions of the host countries are a source of particular concern in connection with efforts to promote democracy in the LCDs. The problem has been succinctly delineated by Gus van Harten, who notes that, ultimately, “arbitrators are able to award damages as a public law remedy without having to apply the various limitations on state liability that evolved in domestic legal systems to balance the objectives of deterrence and compensation against the competing principles of democratic choice and governmental discretion.”<sup>145</sup> As van Harten notes, there is certainly some justification in criticizing the undeniable shortcomings of many of the domestic legal systems – including, everything from inaccessibility, excessive procedural delays, corruption of judges, and other impediments to fairness. At the same time, however, it is not clear that the optimal solution to what is decried as an “absence of the rule of law” is to replace them with an arbitration system that, as van Harten argues, itself subject to the same criticism:<sup>146</sup>

“The problem is unique to investment treaty arbitration because it is a form of (formally non-reciprocal) public law adjudication and because investment treaty arbitrators lack institutional safeguards of their independence, especially security of tenure. This would not be a major issue if the matters decided by the arbitrators were minor concerns or subject to thorough review by an independent court. Neither is true however. Investment treaty arbitrators often resolve, on a final basis, fundamental matters of public law without the prospect of close scrutiny by independent judges, whether domestic or international. As a result, longstanding safeguards of judicial independence in domestic systems of justice have been abandoned in the unique context

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<sup>144</sup> Grubenmann (2010), 33f.; van Harten (2007), 5: “This authority is in certain respects more powerful than that of any court, domestic or international, because the system piggybacks on the rules and structure of international commercial arbitration instead of adopting a more conventional court-based model.”

<sup>145</sup> van Harten (2007), 5.

<sup>146</sup> van Harten (2010), 36.



where foreign investors bring international claims against states and, by extension, the people who are represented by states.”<sup>147</sup>

Van Harten suggests, not without some reason, that a better solution to the deficiencies in local judicial systems might be to address the problems “for all investors, domestic or foreign, and indeed for all citizens” – rather than seeking a solution of dubious legality accessible only to large foreign companies from developed countries.

While concern for the sovereignty and incipient democratic institutions in the host countries have long given rise to criticism of the independent arbitration system for adjudication of FDI disputes, recent awards have also raised the hackles of observers focused on the rights of investors. As Deutsch points out, “a spate of ICSID awards ruling against investors” has led some practitioners and scholars to wonder aloud whether “BIT arbitrations have begun to favor states instead of foreign investors,” and “to consider alternatives to treaty-based investor-state arbitrations and ICSID arbitrations.”<sup>148</sup> Despite the doubts of the “disgruntled parties,” Deutsch points out, the current arbitration system is, in some instances, “the only alternative for foreign investors.”<sup>149</sup> Moreover, it has, in his view, “proven to be an extremely reliable method for settling disputes with foreign states in a neutral setting.”<sup>150</sup> This conclusion is largely shared by Franck, based on an assessment of the influence of two variables, and their interaction with each other, on arbitration outcomes: (1) the development status of the respondent state, and (2) the development status of the presiding arbitrator. “The results demonstrate,” she argues, “that, at the macro level, development status does not have a statistically relevant relationship with outcome” – suggesting, in her words, “that the investment treaty arbitration system as a whole, functions fairly and that the eradication or radical overhaul of the arbitration process is unnecessary.”<sup>151</sup> The difficulty, in Franck’s view lies less in the reality of the arbitration process than in the perception thereof. For this reason,

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<sup>147</sup> *van Harten* (2010), 35f.

<sup>148</sup> *Deutsch* (2011), 599, 600.

<sup>149</sup> See also *Wälde* (2010), 282f., for whom “The foreign investor is in an unequal, hostage-like position subject to the domestic law and government control over the judicial process.”

<sup>150</sup> *Deutsch* (2011), 604.

<sup>151</sup> *Franck* (2009), 435.

she suggests that “particularized reform could enhance the procedural integrity of arbitration” and thus potentially also enhance the “perceived legitimacy of arbitration.”<sup>152</sup>

In order to strengthen confidence in FDI, there is a need for coherence, that is, there must be some guarantee of regularity and reliability to the arbitration proceedings and awards. The publication of awards has created a body of precedent and, at the same time, makes it possible to subject awards if not to judicial, at least to public review. This transparency, more or less imposed from without, is a two-edged sword, however. In addition to exposition the arbitration process to public opinion, it can also cause harm to the reputation of developing countries that are found to be in the wrong, and thus deter or impede further investment there. Recognizing the problem, the OECD, in its 2006 Report,<sup>153</sup> made a study of government proposals for improvements with regard to the publication of ICSID arbitration awards. Its conclusion was consistent with the demands of environmental NGOs, namely that simple publication of the awards is not sufficient; what is needed is greater transparency throughout the entire investment arbitration proceedings.<sup>154</sup> One reason for this is that such transparency could also have an indirect, but decisive influence on the ability of stakeholders to have a say in the proceedings – the outcome of which can well have serious repercussions for them, among other things, by determining their employment prospects.<sup>155</sup> The downside for the host countries is that the relationship of trust that is needed for FDI can be harmed by too much transparency in litigation, so that they are then obliged to make greater efforts to attract

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<sup>152</sup> Franck (2009), 435.

<sup>153</sup> OECD, *Droit international de l'investissement: un domaine en mouvement: complément aux perspectives de l'investissement international*, Paris 2006.

<sup>154</sup> *Bishop/Crawford/Reisman* (2005), 16: “Recently, certain non-governmental organizations (NGOs) have protested the lack of transparency in NAFTA arbitrations because some of the cases involve questions of great public importance like environmental issues.”

<sup>155</sup> Cf. OECD, FN 153, 26: “*Les sentences arbitrales rendues en matière de différends relatifs aux investissements sont susceptibles d'avoir une incidence significative sur le comportement futur d'un Etat, le budget national et le bien-être des habitants. En conséquence, l'intérêt manifesté par le public pour les différends relatifs aux investissements est compréhensible.*”

further investment.<sup>156</sup> With this in mind, suggestions have been made to provide additional mechanisms for mediation between investors and host countries. Richard Deutsch has proposed the introduction of cooling-off periods to provide the LDC with an opportunity to seek mediation or alternative dispute resolution with the investors.<sup>157</sup>

#### **IV. International Investment Guarantee Agencies**

A third instrument established with the idea of promoting FDI by assisting investors is furnished by investment guarantee agencies, which may be either international – such as the Multinational Investment Guarantee Agency (MIGA) or national – like the Overseas Private Investment Corporation (OPIC) in the US, or the *Schweizerische Exportrisikoversicherung* (SERV), Switzerland’s agency for export risk insurance. The role played by such agencies, is largely positive for the LDCs. Among other things, they perform the function of a “gatekeeper” and thus contribute to the sustainability of investment projects in the early phases, before they are eligible for regular insurance. Another positive aspect of these agencies is that they work on a cost-sharing basis, whereby both the investors and the host countries contribute to cover the expense of providing insurance.

##### **A. Nature and purpose of investment guarantee agencies**

Investment guarantee agencies are public institutions that provide political risk insurance to private companies making foreign investments in difficult operating environments. In the period since the end of World War II, nearly all major capital-exporting countries, for the most part the industrialized democracies of the West, have established national agencies that offer such insurance.<sup>158</sup> The first international political risk insurance provider was the MIGA, founded at the initiative of the World Bank, in 1988. Its mission was: “to enhance the flow to developing countries of capital and technology for productive purposes under conditions

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<sup>156</sup> Cf. *Hanessian/Newman* (2009), 248, on the making public of ICSID proceedings: “Once the registration is made public, the image of the host state and the investment climate in that state may suffer, which could lead to a more favorable position for the investor in settlement negotiations.”

<sup>157</sup> *Deutsch* (2011), 589ff.

<sup>158</sup> *Donovan* (2003-04), 11.

consistent with their developmental needs, policies and objectives, on the basis of fair and stable standards to the treatment of foreign investment.”<sup>159</sup>

### **1. Multinational Investment Guarantee Agency (MIGA)**

The idea of establishing a multilateral investment guarantee agency was debated as early as the 1940s,<sup>160</sup> but did not become a reality until some forty years later, with the addition, in 1988, of the newly formed MIGA to the World Bank Group. The MIGA was structured as “a legally separate and financially independent entity,” whose mission was “to complement public and private sources of investment insurance against non-commercial risks in developing countries.”<sup>161</sup> It attempts to do this both by providing guarantees to private sector investors and lenders as a means of aiding investors in gaining access to funding at more favorable conditions than would otherwise be possible. This is in keeping with the World Bank’s mandate “to promote private foreign investment by means of guarantees.”<sup>162</sup> A full statement of the MIGA’s mission is found on its website:

“As a member of the World Bank Group, MIGA's mission is to promote foreign direct investment (FDI) into developing countries to help support economic growth, reduce poverty, and improve people's lives. Concerns about investment environments and perceptions of political risk often inhibit foreign direct investment, with the majority of flows going to just a handful of countries and leaving the world's poorest economies largely ignored. MIGA addresses these concerns by providing political risk insurance for foreign investments in developing countries and dispute resolution services for guaranteed investments to prevent disruptions to developmentally beneficial projects.”<sup>163</sup>

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<sup>159</sup> Convention Establishing the Multilateral Investment Guarantee Agency, effective April 12, 1988, online at <[http://www.miga.org/documents/miga\\_convention\\_november\\_2010.pdf](http://www.miga.org/documents/miga_convention_november_2010.pdf)>, consulted August 19, 2012.

<sup>160</sup> *Shihata* (1986), 272.

<sup>161</sup> See <<http://www.miga.org/>>.

<sup>162</sup> Article I IBRD Articles of Agreement, as amended effective February 16, 1989.

<sup>163</sup> Cf. <<http://www.miga.org/>>.

**a) MIGA Objectives**

In fulfillment of its mandate, the agency “seeks to foster a better understanding of investors’ perceptions of political risk as they relate to FDI.” This includes efforts to explain both the nature of political risk and the benefits of insuring against it.<sup>164</sup> Beyond providing the insurance against financial losses, the MIGA lists the following other benefits that its guarantees furnish:

- (1) Deterring harmful actions by using its leverage as a member of the World Bank Group and its relationship with shareholder governments.
- (2) Dispute resolution by early intervention as an “honest broker” to resolve potential investment disputes before they reach claim status.
- (3) Facilitation of funding access.
- (4) Lowering of borrowing costs through loan guarantees that reduce the risk-capital ratings of projects.
- (5) Extension of repayment dates by providing long-term insurance coverage; the MIGA’s extensive country knowledge and experience with FDI enables it to deal individually with each transaction as circumstances require.
- (6) Aid in compliance with social and environmental safeguards based on the MIGA’s environmental and social expertise.

**b) Sharing of guarantee costs and expenses**

MIGA is funded primarily through its income from premiums and other revenues such as returns on investments. The provisions governing the agency’s finances are found in the MIGA Convention, Article 25f.<sup>165</sup> Its operating income in 2011 was \$23.6 million.<sup>166</sup> Because

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<sup>164</sup> World Investment and Political Risk 2011, <<http://www.miga.org/documents/WIPR11.pdf>>, pp. 1, 44.

<sup>165</sup> The Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) was submitted to the Board of Governors of the International Bank for Reconstruction and Development on October 11, 1985, and went into effect on April 12, 1988. The Convention was amended by the Council of Governors of MIGA effective November 14, 2010.

it is expected to remain viable even when its losses are greater than its reserves, however, it also it relies on a combination of capital subscriptions and “sponsorship” to maintain its solvency.<sup>167</sup> Sponsorship involves the creation of separate “Sponsorship Trust Funds,” kept apart from the Agency’s own accounts, to which member countries – normally the investor’s home country and the host country – contribute. These funds make it possible to offer guarantees that the MIGA, due to the size or location of the investment project, would not otherwise be able to furnish.

The sharing of liability by the home country and the host country certainly has positive aspects to it. At the same time, it is difficult to overlook the incongruence of one of the parties to an agreement providing third-party guarantees to the other party, which is in effect what the host countries are asked to do. The willingness of the LDCs to bear not only their own risks, but also a part of the investors’ risks no doubt increases the willingness of the latter to trust in the host country’s intention to abide by the terms of the BITs, and given their dependence on FDI, the LDCs often acquiesce in such arrangements. This does not, however, alter the fact that the conditions are patently one-sided: as a matter of principle, it is incumbent upon an investor to calculate and manage the risks it accepts in making an investment and, where necessary, to purchase the any additional insurance required. Other questions as to the usefulness of investment insurance for the ostensible purpose of encouraging foreign investment – and not “to extend special legal rights and privileges broadly to an international class of corporate owners of assets” – have also been raised by Gus van Harten. If insurance is so useful for promoting FDI, he argues, it is “anomalous” that “few, if any, investment treaties place enforceable obligations on the home states of investors to facilitate outward investment by...enhancing their programs for investment insurance.”<sup>168</sup>

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<sup>166</sup> Cf. the MIGA Annual Report 2011, *Insuring Investments, Ensuring Opportunities*, p. 5. <[http://www.miga.org/documents/11ar\\_english.pdf](http://www.miga.org/documents/11ar_english.pdf)>.

<sup>167</sup> *Shihata* (1986), 276.

<sup>168</sup> *van Harten* (2010), 29.

## 2. Overseas Private Investment Corporation (OPIC)

The OPIC is a national US agency, established in 1969, with a mandate to ensure project financing and investor services to American companies seeking to invest capital in foreign markets. An amendment to the Foreign Assistance Act makes it subject to the policy guidance of the Secretary of State in the fulfillment of its mission. That mission is “to mobilize and facilitate the participation of United States private capital and skills in the economic and social development of LDCs in transition from nonmarket to market economies, thereby complementing the development assistance objectives of the United States.”<sup>169</sup> These goals are to be achieved through direct and indirect support of development-related projects in eligible LDCs – by making available to investors financing, guarantees and political risk insurance.<sup>170</sup> A key difference between OPIC as a national agency, and the MIGA, as a member of the World Bank Group, is the explicit connection between investment support and the furthering of American foreign policy goals. This includes consideration of the impact of investment projects on the US economy.<sup>171</sup>

## 3. Other national investment guarantee agencies: the SERV

Many other countries, besides the United States, also operate institutions that support foreign investment by providing export and investment guarantees and insurance.<sup>172</sup> An example is the *Schweizer Exportversicherung* (SERV), which describes its *raison d’être* as a “public-law institution of the Swiss Confederation” in the following terms: “As most industrial nations offer their export businesses similar state support, SERV guarantees the competitiveness of Swiss exporters, thereby contributing to the preservation and creation of jobs in Switzerland.”<sup>173</sup> In addition to domestic economic considerations, however, the SERV, which is subject to parliamentary oversight, is charged with furthering foreign policy goals in the

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<sup>169</sup> Amendment to the Foreign Assistance Act in 1969, which is currently codified as 22 U.S.C. § 2191.

<sup>170</sup> *Donovan* (2003-04), 11.

<sup>171</sup> *Masser* (2009), 1711f.

<sup>172</sup> Examples of other national investment insurers are “Pricewaterhouse Coopers Deutsche Revision (PwC), in Germany, and Nippon Export and Investment Insurance (NEXI), in Japan.

<sup>173</sup> See <<http://www.serv-ch.com/en/about-us/>>, consulted August 20, 2019.

areas of sustainable development, human rights, democracy, peaceful coexistence between nations, and protection of the environment. The OECD Declaration is binding on the SERV. Compliance with corporate social responsibility standards is taken in to account as one of the criteria on which the sustainability of proposed projects is judged.<sup>174</sup> In this the SERV policy on investment guarantees is similar to that of the MIGA, whose “policy on social and environmental sustainability”<sup>175</sup> is designed to favor sustainable and environmentally friendly investments by examining the probable social and environmental impact of proposed FDI projects before providing support. In this sense, agencies such as the SERV and the MIGA also fulfill the controlling function of a gatekeeper, by filtering out projects that fail to meet sustainability standards. Thus, for example, in 2009, export insurance policies for the Ilisu hydroelectric power project in Turkey were cancelled because “unfortunately, SERV did not achieve its objective of ensuring that the applicable standards of the World Bank with respect to the environment, cultural heritage and resettlement were observed.”<sup>176</sup> The place of this gatekeeper function within the legal network in which FDI is conducted merits special consideration.

## **B. Investment guarantees as international gatekeeper for sustainable projects**

Investment guarantee agencies such as MIGA, OPIC and SERV operate at the interface between investors, their home countries, international organizations and the host countries. Like BITs and ICSID arbitration, they also contribute to the construction of a global network

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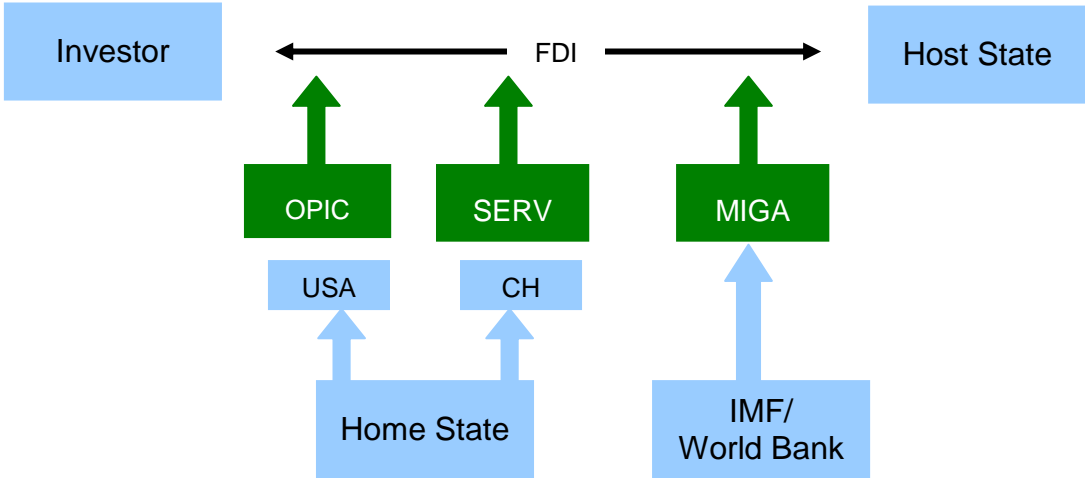
<sup>174</sup> Cf. *Ott/Matthey* (2010), 90; *Kuoni* (2004), 266.

<sup>175</sup> Agence multilatérale de garantie des investissements (MIGA): Rapport annuel 2010 sur les investissements: créer des opportunités, synthèse des activités du Groupe de la Banque mondiale: <[http://www.miga.org/documents/10ar\\_french.pdf](http://www.miga.org/documents/10ar_french.pdf)>; Politique en matière de durabilité sociale et environnementale, 1 octobre 2007: <[http://www.miga.org/documents/enviro\\_social\\_review\\_french.pdf](http://www.miga.org/documents/enviro_social_review_french.pdf)>.

<sup>176</sup> *Geschäftsbericht 2009 der Schweizerischen Exportrisikoversicherung SERV*, Zürich 2010, p. 5, online at: <[http://www.serv-ch.com/fileadmin/serv-dateien/Ueber\\_uns/gb/GB\\_09\\_d.pdf](http://www.serv-ch.com/fileadmin/serv-dateien/Ueber_uns/gb/GB_09_d.pdf)>. *Keim* (2007)ff., at 24: “Namentlich unter dem Druck der Nichtregierungsorganisationen stellten die betroffenen Exportkreditagenturen gewisse Bedingungen, welche die Banken und Bauunternehmen beunruhigten, woraufhin diese sich zurückzogen. [...] Die Bedingungen für die Grundsatzeinwilligung beruhen auf den seit 2001 im Rahmen der OECD bestehenden Umwelt- und Exportkreditkonventionen.”



of law governing FDI. As a government-run mechanism for the protection of private investments, export guarantees cannot be clearly classified as belonging to either public or the private sector. Because they insure only against political risk, they are not, in fact, investment guarantees in the absolute sense. Their effect is only to lessen the risk factor that the political situation in LCDs is considered to represent. The estimation of that risk factor, and the willingness of the governmental, quasi-governmental and international guarantors to mitigate it, thus impinges directly on the relations between the host country and the home country or international organization in question. Because the agencies providing the guaranties, as public institutions, are also subject to regulatory rules, the network of hard and soft law that connects investors, home countries, host countries and stakeholders is further expanded to include the national and international norms to which guarantee agencies and, in the case of the MIGA, the World Bank Group, are subject.



In cases where the guarantees are successful in promoting sustainable FDI, the complexity of this situation, of which the principal beneficiaries remain the privately held companies making the investments, can be justified as nevertheless bringing the benefits of capital flows to the developing countries. Less clear is the situation where an investor makes use of a guarantee and the private investor’s claims pass to the public agency or international organization by subrogation.<sup>177</sup> The guarantors can thus easily find themselves in the position

<sup>177</sup> Ziegler (2010), at 770.

of asserting claims based on non-commercial risks that they themselves create, as in the case, for example, where guarantees are granted to cover the risk of economic embargos. The disparity here is clear if one considers that the home country can thus find itself in the role of the financial beneficiary of private investments whose outcome was influenced by its own political decisions, while it continues to dictate to the less developed host countries the conditions for further FDI – including, in particular, impartiality and fairness in dealings, and respect for the rule of law.<sup>178</sup>

## V. Summary and Conclusions

The erosion of systemic boundaries<sup>179</sup> and the absence of coordination between the different mechanisms in the web of investment protection law remain a subject of controversial debate. The various political and economic arguments put forward by representatives of the private sector, the public sector and the non-governmental organizations differ widely in focus and substance. While there was for many years a broad consensus that FDI was to be regarded overall as a positive phenomenon, even this is no longer taken for granted. The discussion centers mainly on the asymmetrical effects of foreign direct investment, particularly with regard to the economic and legal sovereignty of the host countries. The BITs are criticized as representing a one-way street, where the imbalance between the negotiating power of the multinational investors and that of the individual LDCs has created a situation in which it is only the private investors that benefit from the bilateral agreements.<sup>180</sup> Critics also point out that the exponential expansion of the BIT network has brought it to the limits of its ability to function efficiently creating an increasing risk of fragmentation within the system.<sup>181</sup> In addition, the superior maneuvering ability of the multinational enterprises distorts the legal balance, such that even where massive foreign investment succeeds in generating a degree of economic and social development in the host countries, this occurs without the democratic

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<sup>178</sup> Cf. *Markert* (2010), 38f.

<sup>179</sup> On the notion of eroding boundaries between the legal, economic and political systems of a society, in connection with the financial crisis that broke out in 2008, see *Amstutz* (2011a)ff.

<sup>180</sup> *Diehl* (2008), 11.

<sup>181</sup> *Kononov* (2011) 137ff.,.

participation of the emerging and less developed countries and in such a way that the stakeholders in those countries often benefit only marginally.<sup>182</sup> In addition to the international investment protection treaties, the ICSID Convention is also seen as an attack on the sovereignty of the host countries. The right of investors to sue the host states as parties with equal standing before international arbitration courts is in breach of the traditional understanding of national sovereignty under international law, and adds further to the legal asymmetry in favor of the multinational corporate investors.<sup>183</sup>

To balance this criticism, it may be noted first that the expansion of the originally triangular relationship between investors, their home countries and the host countries, to include both stakeholders and regulatory authorities, has contributed to an increasing tendency toward implementing sustainability and CSR standards, which, if maintained, has the potential to make of FDI a win-win proposition. Secondly, the institutionalization of arbitration instances such as the ICSID, with publication of their case-law, enhances the stability of the procedures and the consistency of the awards; this both raises their credibility in the eyes of investors and helps to make their terms of FDI more transparent to the stakeholders in the host countries. Third, the network effects of investment risk guarantees and their subjection to regulatory controls assort them with a gatekeeper function, which works to the benefit of the local stakeholders. Finally, as long as capital flows form the basis of the world economy, it would be well for all of the concerned parties to consider this maxim posited by Porter and Kramer: “Profits involving a social purpose represent a higher form of capitalism, one that creates a positive cycle of company and community prosperity.”<sup>184</sup>

While the creation of such a “higher form of capitalism” is certainly a lofty goal, however, the reality today is that an imparity remains between the wealthy private investors and the less developed countries in need of their investments. As van Harten remarks: “On the surface, the system of investor protection is the child of states. Yet, non-state strategic actors, i.e. multinational firms, have also played a central role in the creation and ongoing evolution of

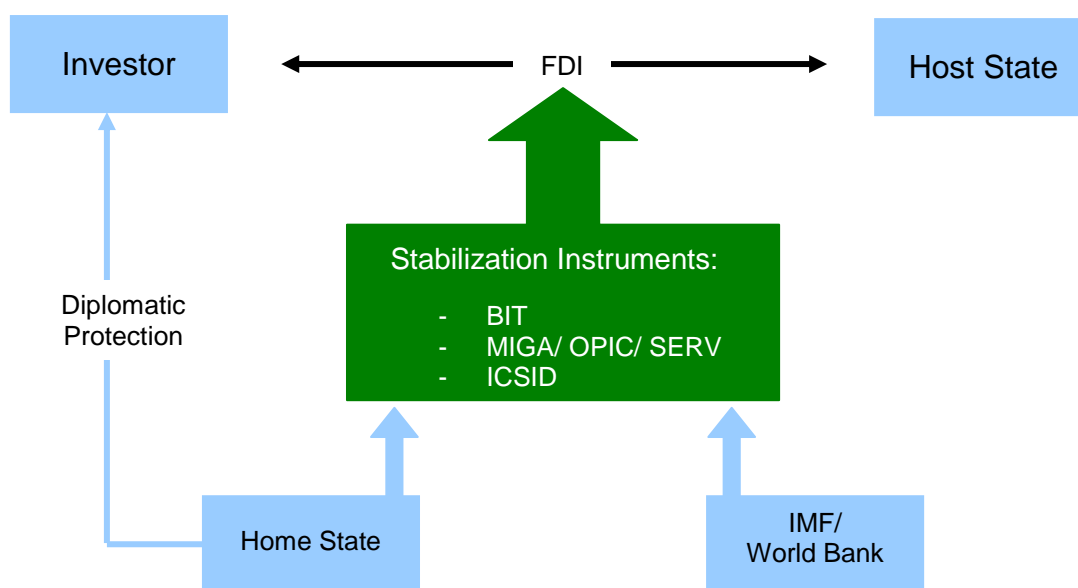
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<sup>182</sup> *Zabriovich Farkhutdinov* (2011) 244ff.

<sup>183</sup> Cf. *Grubenmann* (2010), pp. 9, 161; *Ziegler* (2010), at 755.

<sup>184</sup> *Porter/Kramer* (2011) 75 ff.

the system. (...) Examining the role of these actors reveals the political nature of the system of investor protection, including the role of non-state actors in the expansion of private authority as a method of transnational governance.”<sup>185</sup>



From a legal sociological point of view, what is significant here is the fact that – as has been seen in connection with the international legal and regulatory network for investment protection – within this global web of interactivity, a complex interweave of international and transnational norms are constantly recombining to generate new legal, quasi-legal and regulatory instruments for securing and protecting global commercial and economic exchange. This network of investment protection measures operates globally, with the national legal orders acting to provide stable underpinnings, while the constant adaptation of voluntary standards provides an impetus for evolution in the means used to promote sustainable foreign investment in developing countries.<sup>186</sup> The web of investment protection measures, as we have seen, reacts to the changing demands of global society, and adapts itself

<sup>185</sup> van Harten (2005), 612.

<sup>186</sup> In other words, as expressed by Amstutz (2003) 235ff.: “[...] die vielen Autonomien der [...] Privatrechte [warden] heterarchisch, polyzentrisch, polykontextual, in ‚poietischer‘ Vernetzung verfasst, nicht durch Formalisierung, nicht durch Materialisierung, sondern ‚prozedural‘, d.h. durch Auslösung eines Prozesses, der in seiner Evolution durch Metanormen gesteuert wird [...]“. Cf., further, the CSR Isotope Model in Schneuwly (2011)ff.

accordingly, in a never-ending process. It is this perpetual realignment of national, international and transnational legal systems within the global network of investment protection instruments, at the interface of law, economy and politics, that holds out the greatest promise of bringing about sustainable investments in the countries of the developing world.