

TRANSCRIPT

FOREIGN INVESTMENT ARBITRATION IN THE GLOBAL INTERDEPENDENT ECONOMY[†]

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Thank you very much, ladies and gentlemen, for being here this afternoon and thank you very much also to Professor Bean and the College of Law for giving me the opportunity to speak to you today.

Let me warn you from the beginning that this should be an interactive presentation, that you can, and should, interrupt me with comments and questions, doubts, whatever you think is appropriate; and in this respect, let me start by preaching with an example, and ask a couple of questions for an unofficial poll.

How many of the students here can name an arbitration or litigation case to which a sovereign or a state was a party? Some cases were mentioned today. Anyone remember a case?

Audience: It's not *Brown v. Board of Education*, obviously.

But can anyone name a case involving an investor and a sovereign state? We talked about *Biwater v. Tanzania*¹ and *Loewen v. the United States*² today. There are also a good number of cases that you could find and that involve Argentina or Russia, some of which are frequently discussed in legal forum. Many of these cases are public, that means that they are quoted, that you can go online and download the actual awards and

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1. See *Biwater Gauff Ltd. v. United Rep. of Tanzania*, ICSID Case No. ARB/05/22, (ICSID Arb. Trib. 2008).

2. See *The Loewen Group, Inc. & Raymond Loewen v. United States*, ICSID Case No. ARB(AF)/98/3 (ICSID Arb. Trib. 2003).

procedural orders from the tribunals, and also, in the case of NAFTA³ and now CAFTA⁴ arbitrations, you can even go online and download the pleadings from the parties in those international arbitration cases.

Audience: It considerably increases your workload.

Well, it depends on how you look at it. When you are counsel, it can also make your life easier, in that you can go online and download the pleadings and see how the parties are arguing their cases; sometimes you can even anticipate what the other party may say in your case, because you can see for yourself what your counterparty, or someone in the same situation, has said before in a similar case. It cuts both ways. Excessive information can also make your life very difficult, as you then need to triage it, and see what's useful and what's not.

Now, let's go back to the original question, let's talk for a while about disputes between a foreign investor and a sovereign entity or a state. When you have a dispute of this nature, what are the mechanisms that you can, in theory, consider to resolve the dispute? What are the mechanisms that you can use to resolve the dispute? We just mentioned some. You can go to the courts of the host state. You can go to arbitration. Do you have a sense of which of these two dispute resolution mechanisms is most popular in practice?

Let's go to Europe, for instance. If you were counsel for a privately-owned U.S. company which had invested in, say, Finland, and you had a dispute against the Finnish government, and if you were given a choice (because you don't always have a choice), what would you advise your client?

Audience: You want to get rid of the home court advantage.

Exactly. That's an important difference between mercantile disputes, or disputes involving only entities operating in their commercial capacity, and disputes involving a foreign investor and a sovereign entity or a state. In the case of a dispute between a foreign investor and a sovereign state, many times you don't have any other practical choice but to bring the dispute to international arbitration. Let's say for example that you are the general counsel of a company incorporated here in Michigan, a company by the name of Michigan Turbines Co., a company that manufactures turbines. Let's also say that one day you are contacted, or your company is contacted, by a Finnish company, a privately-owned Finnish company, a company incorporated in Finland, which runs a gas-fired power generation plant that has a need for your turbines; and the Finnish company orders four turbines from you, and you are drafting the contract. And you write down, of

3. See North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289.

4. See Dominican Republic-Central American States Free Trade Agreement, Aug. 5, 2004, available at <http://www.ustr.gov/trade-agreements/free-trade-agreements/cafta-dr-dominican-republic-central-america-fta/final-text>.

course, the usual provisions that you often find in a contract: like the clause containing the contractual definitions, the clause defining the substantive obligations and rights of the parties, the technical specifications that the turbines need to satisfy, and the consideration (in this case the price paid for the turbines). Then you get to what traditionally is one of the last clauses in a contract, the dispute resolution and the applicable law clause.

At this moment you are at ease, and you have perfect freedom to choose the dispute resolution mechanism that you prefer among those available to you (you will later have to see, of course, if the other party accepts it; but that's another issue) of your choice. Now, what are the dispute resolution mechanisms that you might consider for insertion in a contract like this? You have a Michigan-based company, you have the Finnish company. You could certainly add an arbitration clause to the contract. If you do, the eventual arbitral award might be enforceable under the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.⁵ This is one of those international legal conventions that really works well. There are some tweaks here and there; it's sometimes a bumpy road, but generally the Convention is observed and widely applied worldwide, which is a good reason for you to consider arbitration.

What else might you consider? You might consider litigation. Where could you litigate a dispute between these two parties if they disagree?

Audience: Either Finland, the U.S., or you could choose a neutral forum as well, possibly.

The problem with choosing a neutral forum is that many countries don't feel comfortable dealing with disputes and resolving disputes that have no connection whatsoever with them. That was the case for example in the explosion of the Union Carbide gas plant in Bhopal, India twenty years ago. Some plaintiffs, some aggrieved parties, brought a claim in the U.S., and U.S. courts declined to hear that case under a *forum non conveniens* theory, essentially saying, well, this dispute doesn't concern, it has no connection with, the U.S. We might be a neutral venue, or we might be a neutral jurisdiction, because we have no connection with the parties and the issues at stake, but for that very reason, we shouldn't mobilize resources for a case that is of no direct concern for the land.

As you can see, sometimes choosing a neutral jurisdiction, to resolve your disputes, cuts both ways. You could try to go to a neutral forum that is acceptable for the parties, but the forum may refuse to resolve the dispute. Some jurisdictions, especially many of those in the Western hemisphere which apply modern versions of the *forum non conveniens* theory, would be hard pressed to take a case completely unrelated to them, unless a denial of justice may otherwise take place.

5. See Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38.

But you can certainly consider the Finnish courts, and the U.S. courts, to resolve the dispute. Of course, being an MSU J.D., you would be familiar on your own with the U.S. court litigation system. And you could also conduct some due diligence concerning Finland; you could call Finnish local counsel, get him or her to explain to you how the Finnish courts work in practice, how expeditious they are, how reliable they are, and if you are satisfied you might as well end up choosing to litigate the dispute in Finland. So, in essence, you have three choices; in your dispute resolution clause you can agree to arbitrate the dispute, you can agree to litigate it in Finland, or you can agree to litigate it here, in the U.S.

Now, let's move to a different scenario. Let's think that the entity that is going to buy your turbines is not a privately owned Finnish corporation. Let's say that it is a state entity, owned and controlled by the Finnish government. Let's even say it is the Finnish electricity monopoly, which runs a few power plants in Finland. Now you're not dealing with a privately-owned company, you're dealing with the government, wearing the hat of a public enterprise, or a publicly-owned state-controlled entity. And now you're drafting your contract and you need to consider again what dispute resolution clause you include in it. Would you consider litigation? We know that litigation in a third, neutral state may not be available, especially if that state applies modern *forum non conveniens* theories. Still, you might consider litigating your dispute in the U.S., or in Finland. Someone mentioned that before. Would you be happy, would you be comfortable, litigating in Finland? No? Why not?

Audience: I don't think so. The entity in this case is a government-owned company. You're obviously going to be concerned about some sort of bias on the part of the judiciary in Finland.

That is right. However good the court record is in Finland, and it's pretty outstanding, you're still litigating before the courts which are of course an integral part of the same state against which you have a dispute. Let's imagine that the government suddenly decides to cancel the contract for the acquisition of the turbines, for instance, because it has now decided to use only solar and wind energy. If that happened, and as a result, the government tried to bail out from its contract and to avoid paying the turbines it was going to buy, would you be comfortable bringing your claims against Finland *in Finland*? Well, you, as the general counsel of the turbine company, might have a hard time advising that litigating in Finland is the best option for your client.

Now, conversely, can you expect to litigate this dispute here in the U.S.? Number one, the Finnish government is unlikely to agree to that. Number two, would you be able to have a case conducted here in federal court against the Finnish government? It is uncertain. Depending on the nature of the case and the applicable provisions of, among others, the Foreign

Sovereign Immunities Act,⁶ the Finnish government may enter a special appearance in federal court and assert its sovereign immunity. You're familiar with sovereign immunity, aren't you? Ok, just raise your hands if you have any questions related to that.

So essentially, that means that out of the two court litigation options that you might have in theory, neither is really good. This way, arbitration suddenly becomes the most practical dispute resolution option for a contract of the type we have been discussing. This is one of the reasons that arbitration has become a very popular dispute resolution option for disputes between foreign investors and states.

I'm not going to enter into the details as to how you agree to an arbitration of this nature, but for the purposes of this presentation, it will suffice to say, that you can agree to an investment arbitration with Finland in two different instruments. You can agree to it in the contract that you are drafting, or you can have an arbitration consent contained in one of the investment treaties that have been alluded to earlier during the seminar today. So the constitution of the arbitral tribunal can come from two different sources, a treaty or an arbitration clause in a contract. But until the early 1990's, contracts were the usual source for arbitration consents in disputes between foreign investors and states. In the last 20 years, however, bilateral investment treaties have become so widely used, I think there are close to 3,000 in force, that if you are an investor and do some planning and organization of your investment, you can obtain the protection of a bilateral investment treaty in a relatively easy manner. Perhaps you may need to invest through a vehicle established in another jurisdiction, but the odds are that if you have the ability to do properly structure your investment, an investment treaty containing an arbitration consent will be available to you.

Now, the investment arbitration system has been somewhat maligned in the last few years. There has been criticism of sometimes bias in favor of the investor, sometimes excessive leniency in favor of the state. I tend to agree with Rene,⁷ my practical experience is that still, to a degree, investment arbitration has not been as bad for states as sometimes argued by certain governments. In commercial arbitration, for instance, you can easily see awards in amounts exceeding one billion dollars being issued in favor of one party. And that's virtually unheard of in the investment treaty and the investment arbitration system nowadays. The largest awards are usually in the region of 300, 400 million dollars.

In any event, despite some criticism of how the system works, the important thing I'd like you to remember is that sometimes arbitration is the only available, the only reasonable option for resolving investment disputes.

Is there anyone here from Mexico, or anyone familiar with Mexico? O.K., thanks. Between 1864 and 1867, Mexico had an emperor,

6. See 28 U.S.C. §§1602-1611 (2006)).

7. Rene Cardieux

Maximilian, from the Habsburg dynasty. And he was not enthroned by the Mexican people, he was enthroned by Napoleon the Third, then Emperor of France. Napoleon the Third, with support from the Spanish and the British fleets, invaded Mexico in 1861. One of the reasons, the official one, given for the intervention was that Mexico had defaulted on its loans vis-à-vis some French private banks. The government of Mexico had not repaid some loans that the French banks had made to the Mexican government.

So here you have the classic investor-state type of dispute, in which the investor, back in the 19th century, had no specific remedy and had no standing to bring the dispute before an international forum. His claims back then were simply taken or espoused by his home state, which pursued them if, how, and when it considered appropriate. And in this case, Napoleon the Third, head of the investor's home state decided to resolve the dispute his own way, by invading Mexico. That was not an unusual occurrence in the 19th and the earlier part of the 20th century. In 1902, Britain, Germany, and Italy imposed a naval blockade on Venezuela until Venezuela made its then outstanding payments to bondholders from those nationalities.

Later in the 20th century, investment disputes were sometimes resolved through trade wars and trade sanctions. States then said: If I see that a foreign government is not repaying loans to my own nationals, what I'll do is I'll essentially raise import duties on the foreign goods coming from the state which failed to repay the loans. Or I'll no longer trade with that nation which has failed to repay my own nationals.

So in some respects, when nowadays countries such as Bolivia or Ecuador make declarations to the effect that they may leave the foreign investment arbitration system, the risk is that there is no serious, effective alternative to a solid supranational mechanisms for the settlement of investment disputes. You cannot go back to the — I won't say the 19th century days — but to the mid-20th century days during which trade sanctions and severe restrictions were frequently used. Those sanctions and restrictions were oftentimes more damaging in economic terms for the host state than any adverse award that could be rendered in the foreign investment arbitration system. So with all its imperfections, arbitration still remains an effective way to resolve investment disputes. It may be perfected, it may be replaced with a supranational investment court, but it cannot be credibly buried without having an alternative in place.

Now, one of the greatest upsides of the foreign investment arbitration system, as we know it, is that it affords standing to private companies to sue states directly. This means that the resolution of the dispute is not done state-to-state, through gunboats, trade sanctions, etc. as in the 19th century and the earlier part of the 20th century.

Until, essentially 1965, private companies couldn't sue a foreign government in an international venue, if a foreign government had somehow failed to fulfill its contractual obligations, or somehow failed to abide by its international commitments vis-a-vis an investor. That changed,

essentially, with the World Bank system. Do you know, or are you familiar with, the World Bank system? Do you know how it works in practice, the different agencies?

Well, the World Bank is made up of different agencies. Some work, and I use the term very loosely, some work as an insurance agency for investors who invest in certain countries, and provide insurance, for instance, for political risk. And the World Bank also works as a lending institution, loaning money for developing countries, and loaning money for certain projects that may benefit developing countries. But the World Bank also offers mediation and arbitration facilities. The World Bank agency which runs these facilities is known as ICSID, the Centre for Settlement of Investment Disputes. And it works more or less like as an international arbitration and mediation institution. With some significant differences given the particularities of the foreign investment system, ICSID works more or less in practice like, for instance, the Court of Arbitration of the ICC, the International Chamber of Commerce in Paris, a major international arbitration provider. A significant difference being, however, that while the ICC administers almost all types of international arbitrations, ICSID will only administer arbitration cases involving a sovereign state or a designated state entity and a foreign investor that is a private investor from a different country.

Now ICSID was set up by means of the 1965 Washington Convention⁸ which was devised by Aaron Broches. Aaron Broches was a Dutch lawyer and the general counsel for the World Bank. And he had this vision. He thought that part of the problem, or part of the reason that investment was not really flowing abroad to developing countries, was that sometimes investors were afraid that if the government from a developing country didn't repay the loan or the promissory note, if the government didn't pay for the turbines, or if the government suddenly changed the rules of the game in the middle of the game by for instance, raising taxes by 80 percent, then they would have no direct remedy. Investors would be left unprotected in a case like that. They would have to resort to the government from their own country, tell it about the claim related to their investment and hope that the government of their country of origin would espouse that claim, and somehow decide to address it, diplomatically or otherwise, with the investment host state. In practice, this meant that the investor frequently went unpaid and did not receive any effective reparation.

So Aaron Broches thought that investors had to be granted standing to bring their own claims against states. This idea was, of course, much easier to accept for host states, as it gave them a straightforward and more predictable dispute resolution path than the previous gunboat diplomacy and trade wars. That's how the current foreign investment arbitration

8. See Convention on the Settlement of the Investment Disputes Between States and the Nationals of Other States, Mar. 18, 1965, 17 U.S.T. 1270, 575 U.N.T.S. 159.

mechanism was established. Now, this mechanism has been working and has been expanding, more or less on a regular basis, in the last forty years, with investment arbitrations becoming increasingly more frequent. Its wide acceptance doesn't mean that the system is flawless, but the system essentially adds some predictability to investment relations, as well as protections for both the investor and the host state.

Now, I committed to talk a bit about the impact of the current economic crisis on international arbitration and arbitration for investors and states. How do you think the economic crisis is affecting the global dispute resolution system? Do you think we are likely to have more disputes now that there's a crisis (including more disputes between foreign investors and states), or do you think we are likely to see less? What are your views on that?

Audience: There will be more defaults on loans and things like that, so I think that as the economic crisis worsens, I think you're going to see more disputes, more everything.

That's conventional wisdom, that in times of economic crisis you'll see more defaults. And companies and states have less money, so that they need to fight for every dime. And the expectation is that you might see an increase in disputes. I'll get to that in a second. Reality, however, is much more complex than conventional wisdom would have it. I can give you an example. The last six or seven years some governments in Latin America, Africa, the Middle East, and other regions in Asia have been engaged in what some people call petro-nationalism. Many of these governments have large oil and gas fields. Yet, they somehow lack the technology or the money to explore and produce oil and gas from those fields, so they've traditionally needed foreign investors to do that. And, as a result, in many cases, those investors have entered into exploration and production sharing contracts with the government that had a duration of 20, 30, or even 40 years.

In recent years, however, some of these governments have decided to increase taxes and royalties for those contracts or to impose a renegotiation of them. So now, some investors have to pay significantly higher taxes than what they had paid for earlier on. In some cases, and I am not saying this is always true, but in some cases, these petro-nationalistic measures constituted a breach of international standards. They may amount, for instance, to a breach of the unfair and inequitable treatment standard or of the expropriation standard set forth in many bilateral investment treaties. Now, when these breaches took place, some foreign companies had potential causes of action against the host governments which appeared to be breaching international law. However, only a few companies actually brought claims for those breaches.

In fact, many companies decided not to sue the host governments, because they said, "when we modeled these contracts, when we modeled these investments, oil prices were at \$35 a barrel, or even lower. We then

had these long-term production sharing agreements with the government, and we never thought oil prices would go higher than \$55 a barrel. Now it's at \$120, \$130, so we're making more money than we ever expected. So yes, admittedly, the government is taking more money from us through taxes and otherwise than we thought it would, but on the other hand, we are still exceeding our best expectations, so we will probably preserve our long-term deal with the government and not upset them by bringing claims against them."

Now, the situation has changed. Those very same companies find themselves now in a situation in which the markets are lower and oil prices are sinking below the \$55 per barrel level or below the levels at which they legitimately expected to operate. So going back to John's original point, that would support the idea that perhaps those companies would now reconsider, to the extent they still have claims under international law that have not been waived, they might reconsider the decision not to sue a foreign government which is arbitrarily raising taxes, expropriating them, or treating them unfairly and inequitably. Those companies' revenues have been affected and are now below what they originally planned or legitimately expected to receive. This is why dispute resolution long-term planning and the preservation of rights are always important. Preserve your rights and claims now because later on you may end up deciding to exercise them.

But the flip side, and what makes the whole situation very unpredictable, is that international arbitration cases are expensive (often exceeding five million dollars in fees and costs per party), and as I said before, in investment arbitration the awarded damages are not always as high as foreign investors would expect and are frequently entitled to. When you're the general counsel of a corporation, you usually have a limited budget for litigation. If you're a mid-size company, and you're the general counsel, or the head of litigation, you might have five or seven million dollars for yearly budget for settling company disputes, and anything that exceeds that budget would be an extraordinary expense. So, it might not be easy for a general counsel to move out from that framework. And sometimes, foreign investment cases against a sovereign are very costly, and regrettably, under existing practices, there is no guarantee that you will be awarded costs even if you prevail, or that the damages in the award will get close to your actual loss or the amount you were claiming.

Occasionally in purely contractual disputes you have a damages liquidation clause that somehow facilitates the calculation of damages a party is entitled to seek. That, however, seldom happens in an investment dispute. In an investment dispute, usually, and simplifying things very much, the measure of damages is the delta between what you actually obtained from your investment and what you would have been entitled to obtained if the government had not interfered with it or wiped it out.

That delta is complicated to calculate, especially for long-term contracts. I mean it's hard to calculate the expected revenue of the foreign oil company which has a forty-year deal with the government, for the exploration and development of some oil fields that is suddenly and in the middle of its existence terminated or significantly taxed by the government. What is the amount of damages then? Well, this figure depends on a vast number of factors, such as what are proven reserves from the field and how easy is it to produce oil found there? Is it heavy crude? Light crude? Hard to refine? What would you expect oil prices to do during the remaining years of the contract? Would they go up? Would they go down?

Add to that the complexity, in my view, the reluctance, from some investment tribunals to award large damages and the situation is made even more difficult. For some arbitrators, in calculating the amount of damages, you should take into account the impact that the award may have on a state's annual budget or the percentage it represents from the nation's GDP. If the impact or the percentage is too large, well then, some arbitrators say, we should perhaps lower the amount of damages awarded. This is a very problematic way to approach damages that, in my view, is not helping international arbitration nor is consistent with international law requirements.

So, back to my original point, what I wanted to say is that it's sometimes expensive to arbitrate these cases and the ultimate amount of damages you may get is uncertain. And in times of crisis, it's unclear which way companies will go. The only way to make the system work, the only way to preserve the availability of international arbitration as an effective dispute resolution mechanism for investment disputes, is to ensure that the tribunals are more courageous than they have thus far been in awarding damages and allocating costs. This means awarding the damages sustained by the claimant, however large or small, and ordering, more frequently, the losing party to pay all or most of the costs incurred by the winning party. Otherwise, at some point these cases will no longer make sense from an economic standpoint. The cost-benefit analysis of bringing these cases, if things do not change, may continue to be negative.

And this is a significant difference between commercial arbitration and investment arbitration. Commercial arbitration cases involve two parties acting in their commercial capacity, meaning that neither is or has acted as a sovereign. As I mentioned before, arbitration tribunals have traditionally been less reluctant than investment tribunals to award costs and large amounts of damages in commercial cases.

Another significant difference between investment arbitration and commercial arbitration is that, in investment arbitration you probably see a lower settlement ratio. I think that everyone might have a different experience, but mine is that about 50 to 60 or 65 percent of commercial disputes end up being settled at some point, before the final award is issued. However, I have seen significantly less settlements of investment disputes.

Can anyone guess why that happens, why sometimes it might be harder to settle an investment dispute with a sovereign?

Audience: The valuation of what your investment is going to be worth is going to be so, I mean obviously the person who's investing is going to have — they are probably going to be so far apart that it's not, ever going to

That is right. That might be a factor, but that also happens in commercial disputes. Can you think of other reasons?

Audience: If you have a state party involved, then the state party might be less likely to settle with a merchant because they have

Why should they be less likely to settle?

Audience: Theoretically, the resources are where the party probably has more money.

Well, it's become very sophisticated already. Several host states have many years of experience in arbitration and retain expensive and experienced law firms to represent them in investment cases. I agree with both of what you said. I think that bureaucracy, the complexities of the host states' legal and political system, and also strategic gambits all play a role. Sometimes administrations say, "Well, if I settle this case, my voters are going to think that somehow I've sold my soul to foreign multinationals. They're not going to be happy with me. Whereas, if I let the case go by, well, I might lose, but then I can put the blame on foreign multilateral institutions, the World Bank, neo-colonialism and all that," and you know, you might actually lose but no longer be in power by the time the final award comes down. That's happened in the past. It takes sometimes three, four, five years to get an award, so by the time the government loses the cases the previous administration may no longer be in power and the problem would no longer be theirs. I remember having settlement talks with a Latin American country, where we met with three different ministers of economy, and with five different ministers of development over a five year period. So administrations keep changing, and the dispute is a hot potato that one administration keeps passing to the other.

Additionally, a lot of countries, especially developing economies have strict accounting policies and aggressive district attorneys that sometimes use their power to participate in the political process. Thus, if members of an administration agree to make a payment to a foreign corporation they can be audited and perhaps criminal charges may be brought against them, on real or artificial grounds, that they might be making an inappropriate use of public funds. So settling a case might be a source of personal problems that some officials in certain countries may try to avoid.

