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# THE INAUGURAL BROOKLYN LECTURE ON INTERNATIONAL BUSINESS LAW: “ISDS: THE WILD, WILD WEST OF INTERNATIONAL PRACTICE”

*George Kahale, III\**

I understand this is the inaugural Brooklyn Lecture on International Business Law, and I’m quite honored to have been invited to deliver it.

I’ll be talking about the system of investor-state dispute settlement. It’s a system I’ve been able to observe up close for more than a decade now, after spending most of my career as a corporate lawyer who dabbled in conventional litigation. I did what lawyers often do, which is to follow my clients, many of which happen to be governments. Over the last decade, their most daunting legal problems have been defending themselves against the onslaught of investment claims. I thought it would be both exciting and challenging to follow them into this new area of practice, which didn’t even exist when I graduated from law school. What I didn’t know was that I was entering the Wild, Wild West of international practice.

ISDS is a system created by states through a network of over three thousand bilateral and multilateral investment treaties that provide a number of protections for investors from one contracting state in the territory of another. What gives those protections teeth are the dispute settlement provisions of the investment treaties, usually arbitration at ICSID, which is the International Centre for Settlement of Investment Disputes, or under the UNCITRAL or other well-known procedural rules.

The United States is currently a party to many of these treaties, perhaps the best-known being the North American Free Trade Agreement. One hears a lot about NAFTA these days. It’s one of those trade agreements Mr. Trump likes to trash as a “bad deal,” or a “very, very bad deal.”<sup>1</sup> But we don’t hear as much

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\* The lecture was delivered on April 3, 2018 at Brooklyn Law School and was sponsored by the Dennis J. Block Center for the Study of International Business Law and the *Brooklyn Journal of International Law*. Professors Robert Howse and Julian Arato provided comments following the lecture.

about Chapter XI of NAFTA, the one dealing with investment protection, which is what we are talking about today.

Now, why do I call this the Wild, Wild West of international practice? First, because while one can detect the trappings of a legal system, in a real sense that's all they are, trappings. There really are no hard and fast rules. Briefs, motions, oral arguments, discovery and trials are all nothing like what you see in federal court. Briefs in arbitration can run into the hundreds of pages, often dealing simultaneously with the full gamut of factual, legal, technical and economic issues, challenging the digestive capacity of even the brightest and most competent of arbitrators. Speculation and shoddy reporting in newspapers passes as evidence. Misrepresentations of fact and gross miscitations of authorities are rampant and, when discovered, usually go unpunished. Teams of lawyers meet in conference centers and hotels in wonderful locales all over the world to do battle under the supervision of ad hoc tribunals, also flying in from all corners for a few days of drama before all pack up and rush to catch their flights home. Many of the players in this game know and respect each other, like the gunslingers of the Wild, Wild West, and one can detect a certain unwritten code of conduct, like lining up for the ceremonial handshakes, but a disciplined litigator used to proceedings right here in the Southern or Eastern District of New York is at a distinct disadvantage playing by the rules of conventional litigation when everyone else is in gloves off, anything goes mode.

Let me just give you a few examples of what you need to be prepared for if you choose to make a living in this area of practice. In one case, the main documents on which a billion dollar-plus claim was based turned out to be forgeries, but the claimant still managed to avoid dismissal for about four years, and then had no problem proceeding to challenge the dismissal in annulment proceedings. In another, the key document evidencing the investment was also a fake, and if it were not for one of our associates figuring that out because the phone number on the letterhead didn't even exist in that country at the time, no one would have known. Now you might have thought both of these claims would have been thrown out immediately, but that's not how it works in ISDS. In fact, in the case of the phantom number, the claimant actually obtained a small award, showing that while forgery is not a good thing, it isn't necessarily fatal to an ISDS claim.

In yet another case, we were shocked to see that in support of an argument for disqualification of an arbitrator, counsel had introduced an April Fool's joke about a supposed merger between two countries, which supposedly justified summing the arbitrator's appointments from each country in determining whether the arbitrator should be disqualified. I almost fell off my chair when I saw that. You could tell just by reading the heading of the article that it was a joke, but it was still submitted in all seriousness. How does one begin to answer that?

I also remember that in my opening statement in one case I had to point out that an expert report submitted by one of the world's most renowned figures in public international law, who was sitting there listening, contained an obvious mischaracterization of an exhibit around which a significant portion of the claimant's argument had been built. I said I was curious to see how he would explain that when he testified. When he took the stand, the first thing he did was to say that after listening to me, he had decided to amend his report. He simply deleted the part I was curious about and continued his testimony unabashed, as if the "no harm no foul" rule applied.

I could go on and on with these examples, including: instances of mistranslating and even misquoting laws and court decisions to say something very different from, and sometimes the exact opposite of, what they say in the original version; writing affidavits for fact witnesses that the witnesses could barely recognize, much less defend on cross-examination; citing cases and documents for propositions they do not remotely support; and wholesale invention of legal principles, and even facts—what we in this country now refer to as "alternate facts"—all without any material consequence when exposed.

All this presents special challenges for lawyers who have to navigate through this caricature of a legal system. In some ways, ISDS tests a lawyer's skills the way no other practice area does. It can be entertaining and even exhilarating for us lawyers, but the unfortunate reality is that it is downright dangerous, not to the players in this game, but to those who created the system and are always on the receiving end of claims: the states.

Why do I say dangerous? Because we have something posing as a developed legal system in which billion dollar claims created out of thin air have become commonplace and, believe it or not, actually have a chance of success. We're talking about claims that can bust the budget of most countries, not a laughing

matter, claims that in too many cases would be laughed out of court in any mature and reputable legal system.

We don't have time today for an in-depth examination of all of the deficiencies of ISDS, most of which I have discussed at some length elsewhere. They include: the way tribunals are formed; the lack of meaningful arbitrator qualifications or serious standards for arbitrator disqualification; the inherent bias in the system against states, the absurd legal interpretations given by some tribunals to basic international law principles—interpretations that wouldn't pass muster in International Law 101—and the relatively unchecked powers of arbitral tribunals due to the lack of a reliable post-award review mechanism.

Much of the problems associated with ISDS can be traced to the influence of commercial arbitration. The *raison d'être* of commercial arbitration is to provide a speedy, cost-effective and neutral means of resolving commercial disputes. The idea is to settle and move on, not to uphold some grand principle of international law. Commercial arbitrators are not often called upon to decide matters of policy, to review the wisdom of national legislation, to tell a government what tobacco regulations go too far, how much taxation is too much taxation, how to exercise its police powers or what measures are appropriate for its national security. Yet those are the kinds of issues that tend to be front and center in ISDS.

It's one thing to have party-appointed arbitrators negotiate a decision to settle a commercial dispute having no particular significance beyond the case at hand, trading points and compromising in the interests of arriving at a commercial result that may not fully satisfy either side, but allows both to move on with their business and even continue to work together; it is quite another to decide fundamental issues of international law and policy that affect an entire society, not to mention the international community in general. In other words, one should not assume that mores and practices suitable to one field can simply be transplanted into another. Yet that is what has happened, and it is a partial explanation for the contradictory and even incomprehensible decisions we have too often seen in investor-state arbitration.

As in commercial arbitration, plainly wrong decisions are difficult to overturn in ISDS. The New York Convention and most domestic legislation on the subject are designed to limit grounds for challenging awards. The ICSID Convention also has limited

grounds for annulment. The best example of that, which hopefully will not be followed, is the *CMS* decision. The annulment committee there refused to annul an award against Argentina that it had found was riddled with manifest errors. As I've asked on previous occasions, how is anyone supposed to feel when told: "sorry, you were obviously right, but you lose anyway?" It's one thing to say the call on the field stands when the replay is inconclusive, but how can you defend the call when the replay shows conclusively that it was wrong? What is the point of having a review mechanism if you can't correct manifest errors?

I also have difficulty with the argument, which is actually taken seriously in some circles, that one should hesitate to annul an award even if it makes no sense because the nonsensical part may be the result of the normal give and take in tribunal deliberations. Defenders of that position find comfort in annulment decisions containing statements such as this: "[A]nnulment committees should not be quick to find contradiction when in fact what is evident from the award is the compromise reached in an international collegiate adjudicative body." As you may know, inability to follow a tribunal's reasoning from point A to point B is considered a ground for annulment of an ICSID award. I don't know how you can apply that standard if you overlook contradictions in a tribunal's reasoning on the ground that they serve the greater good of reaching agreement within the tribunal through compromise. I'm all for collegiality, but it should not be used to shield legally indefensible decisions from review.

The combination of a lack of clear legal standards for basic concepts such as fair and equitable treatment, one of the most abused concepts in ISDS, with the inapplicability of *stare decisis* and the lack of a serious review mechanism leads to what is sometimes referred to as the sovereignty of tribunals. Translated, that basically means each tribunal is free to create its own law, and often does.

What's important to understand is that virtually all new developments in this field go in the direction of expanding investor protection beyond anything imagined by the states that created the system. That's why you see more and more criticism of ISDS among states, international law scholars and public interest groups concerned about the deleterious impact of ISDS on the public interest and the development of public international law. You may be familiar with one of the earlier expressions of discontent from those corners, in which a group of distinguished

law professors put together a statement on ISDS that complained of “overly expansive interpretations of language in investment treaties” and “unduly pro-investor interpretations” of concepts such as fair and equitable treatment.

More recently, in an open letter to President Trump, 230 law and economics professors publicly urged the administration to get out of the NAFTA investment chapter. They said, “We are writing to urge you to remove ISDS from NAFTA, as well as to leave ISDS out of any future trade or investment pact.”

Now, you wouldn't think that type of letter would mean anything to Donald Trump, but the Administration apparently is seriously considering opting out of ISDS in NAFTA—you may have read about the USTR's testimony in Congress on this a short while ago. It seems that the idea of withdrawing from NAFTA's ISDS chapter is motivated by a belief that no international tribunal, whether it be the International Court of Justice or the International Criminal Court or any other international court, should have jurisdiction to decide anything against the United States. Nobody tells the America Firsters what to do. The Administration apparently also believes it should not be providing insurance for American business abroad because that would promote the exportation of jobs. I don't necessarily subscribe to the Administration's reasoning, but it just so happens that in this case it might lead to the right result. In other words, if the Administration actually does withdraw from Chapter XI of NAFTA, even if for the wrong reasons, it will have taken a step in the right direction on ISDS, and I will be pleased that there's at least one policy of this Administration I can support.

I briefly mentioned earlier that what makes ISDS especially dangerous is not just the matters of principle at issue, but the sheer magnitude of the claims. Although I take a back seat to no one in acknowledging the importance of principle, one can only get so worked up if the disagreement is largely academic. But we are not just talking about pollution of the classroom here; we are talking about claims the size of which has never been seen before anywhere.

When I started practicing, a multimillion-dollar claim was big. Now we've reached the point where a law firm can have a portfolio of 50 or even 100 billion dollars in claims at any given point in time. The last time *The American Lawyer* did its firm rankings in international arbitration, it only counted the number of billion dollar claims handled.

You might say, “Well, it’s easy to claim anything, but no one would ever expect to actually get an award like that.” Maybe that was the case a couple of decades ago, when ISDS was just getting rolling, but not now. In 2012, for example, a tribunal rendered an award against Ecuador which with interest came to over \$2 billion USD, and that was after the claimant was found to have breached its agreement. An annulment proceeding reduced the award by approximately \$700 million USD because Occidental had transferred a portion of its interest in the oil project at issue, but what remained was still the largest ISDS award in history. That was a record that might have been expected to stand for a while, but less than two years later, another tribunal rendered an award of approximately \$50 billion USD in the *Yukos* cases, or more than twenty times the previous record. The claim was over \$100 billion USD. That case is still in court in the Netherlands, with the court of first instance having set the award aside on jurisdictional grounds. I don’t know what will happen in the higher courts, but the point is that these types of awards are not only shocking; they constitute a real threat to international peace and security. If you don’t believe that, just think of what the America Firsters would have to say and what they might do if someone tried to enforce a 100 or 50 or even \$10 billion USD award against the United States.

Now I’ll just highlight a couple of features of ISDS that deserve special mention when it comes to quantum. First is what is sometimes referred to as the “anchoring” strategy. That’s the term used to describe the strategy where a claimant makes outlandish damage claims at the outset of a case in the hope that the tribunal will then consider less absurd, but still grossly exaggerated claims to be somewhat reasonable. It’s not a new strategy. Long before the advent of such claims in ISDS, we became familiar with multimillion dollar claims for coffee spills and minor traffic accidents. But ISDS has taken the anchoring strategy to an entirely new level.

Quantum in ISDS is not a matter of putting a number on damages for concepts, such as pain and suffering. It’s a very sophisticated analysis that has given rise to a whole new profession of highly skilled experts who support damage claims with extraordinarily complex and lengthy economic and financial reports that most lawyers and arbitrators have difficulty understanding and evaluating in the relatively short time allotted.



For those of you who are interested in litigating ISDS cases, it is imperative to grasp the basics of recurring quantum issues, including the discounted cash flow methodology used to value an interest. The object of DCF is to ascertain the market value of an interest by estimating the future cash flows it is expected to generate and then applying a discount rate to arrive at a net present value. The first step in the analysis is projecting cash flows for the life of the interest, which requires a projection of each of the inputs into those cash flows—operating costs, capital expenditures, taxes, production, sales and prices. Common sense tells you that even the best of those projections will be wrong over a period of ten, twenty or thirty years, the only question being by how much. The battle is over the assumptions concerning each of the inputs, and the potential for abuse is enormous. That's no doubt why the World Bank Guidelines on the Treatment of Foreign Direct Investment warn that “[p]articular caution should be observed in applying this method as experience shows that investors tend to greatly exaggerate their claims of compensation for lost future profits.”

One of the principal reasons for the proliferation of billion-dollar damage claims in investor-state cases is the ingenuity of claimants and their experts in giving what ordinarily would be considered surrealistic valuations the appearance of a sound theoretical foundation. In many cases, this involves: breaking new ground by convincing tribunals to apply DCF even in the absence of a track record of profitability—something the World Bank Guidelines consider inappropriate; then providing all sorts of technical and industry analyses to support the most optimistic cash flow projections that pass the laugh test; and finally, spinning theories to support the lowest possible discount rate to bring the cash flows back to the valuation date, which of course, results in the highest net present value.

The discount rate is often the single most important issue in the quantum phase of an ISDS case. To give you an idea of why so much time and effort is spent on it, just take this simple example. A cash flow of one million per year over a twenty-year period has a present value of 4.87 million when discounted at an annual rate of 20 percent, but when discounted at the rate of 10 percent, the present value is almost double. In the *Occidental* case, the tribunal applied a 12 percent discount rate to arrive at an NPV of about 1.8 billion. You would have to see the cash flows to know exactly what the impact would have been if an 18

percent discount rate had been applied—that's the rate chosen by the two *Mobil* tribunals for valuation of oil interests in Venezuela around the same time period, and at that time one would have thought that the discount rate for an oil project in Ecuador should have been higher, not lower, than the rate for an oil project in Venezuela. The simple choice of a 12 percent discount rate meant that the award in *Occidental* was probably hundreds of millions of dollars higher than what it would have been if the approach of the two *Mobil* tribunals had been followed.

Even more difficult to understand is how the tribunal in another case, *Gold Reserve*, could come up with a discount rate of around 10 percent for a project in Venezuela, resulting in an award of over \$700 million USD, when the discount rate applied by the *Tidewater* tribunal for the same country was around 26 percent, and the claimants in the two cases used the same expert, making the same basic arguments, successfully in the first case, unsuccessfully in the second. Had the *Tidewater* discount rate been applied to value the interest in *Gold Reserve*, the result would have been a fraction of the \$700-plus million USD awarded, again a difference of hundreds of millions of dollars. And if you think that's huge, I can tell you that there are other cases where the difference is not just hundreds of millions, but actually billions.

The last point I'd like to mention is that there's a relatively new phenomenon called third-party funding that has increased the danger posed by ISDS exponentially. Investment treaties are supposed to protect the investments of those who put their capital at risk to develop a business and contribute to the economy of the host state. I doubt seriously that any government had in mind protecting litigation speculators when they signed up their investment treaties. That is not exactly traditional foreign investment, but it has become a major feature of investor-state arbitration, as a significant percentage of investment claims are now sponsored by third-party funders. I understand the argument that third-party funding allows claimants to obtain justice that might otherwise be out of reach, but third-party funding is more about making money than obtaining justice, and the well-known deficiencies of ISDS are precisely what make ISDS fertile ground for funders.

Third-party funding is a bit like drilling for oil. You know you'll be drilling a lot of dry holes, but one discovery can make it all worthwhile. It doesn't take much to commence an arbitration

and see it through the exploration phase, especially the all-important formation of the tribunal. This means that an investor losing an investment of a few hundred thousand or a few million dollars through some combination of governmental regulations, adverse market conditions, incompetence and plain bad luck may find itself holding a marketable asset worth many times the amount of its loss. Imaginative counsel can construct an FET claim out of virtually any set of facts, provided there is some governmental action in the picture, and any number of experts can be lined up to calculate the millions or even billions in profits that the business would have made if only it had been treated fairly by the host state. With the right tribunal and a state caught off guard or otherwise unable to manage the situation, the stage could be set for an award that transforms a bad investment into a windfall for both the investor and the funder.

In closing, I'd just like to say that I don't mean to depress ISDS enthusiasts or to discourage students from pursuing courses in this field. As I said at the outset, this field will test your raw legal skills perhaps like no other, and it certainly is interesting. But it's important to go into it with eyes wide open and to understand that there are serious problems that may not be solvable in the near future. UNCITRAL now has a working group to address ISDS with a mandate to identify and consider concerns, to consider whether reform is desirable and, if so, to develop any relevant solutions to be recommended to the Commission. I'm not expecting meaningful reform any time soon, and in fact I wonder whether any reform might be a case of the cure being worse than the disease. That's especially true if, as appears to be the case, the main efforts at reform are directed not to questions of substance, but to the creation of institutions such as permanent investment courts and appeals tribunals that at this stage can be expected to build upon and institutionalize the serious flaws in the existing system. I think it is better to recognize that the system was poorly designed and has been malfunctioning for three decades, and that dismantling it and starting from scratch is the wiser course. But that's a discussion for another day.

Thank you for your attention.