The Influence of the Host State's Level of Development on International Investment Treaty Standards of Protection

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I. INTRODUCTION

An investor choosing between investing in two diverse countries will, among other factors, look to the standard of protection they can expect from the host state.[2] After the recent explosion in bilateral investment treaties ("BITs"), the investor will increasingly be able to look to the provisions of such a treaty to determine those levels of protection. Due to the largely homogenous nature of modern BITs, the investor is likely to encounter similar provisions. For example, on the face of the treaty, a US investor is offered a similar standard of protection when they invest in a developed country, such as Canada, and a less developed country, such as Moldova. If the investor invests in Canada, they are guaranteed, inter alia, "treatment in accordance with international law," including "fair and equitable treatment" and "full protection and security."[3] If the US investor invests in Moldova, they are guaranteed, inter alia, treatment not "less than that required by international law," as well as "fair and equitable treatment" and "full protection and security."[4]

Reading these provisions, the US investor could be forgiven for thinking that they can expect the same standard of treatment whether they invest in Canada or Moldova. The US investor could also reasonably expect that they can claim compensation if either the Canadian or Moldovan government fails to provide that standard of treatment. Both the North American Free Trade Agreement ("NAFTA") and the US-Moldova BIT offer investors access to independent arbitration to seek compensation for the host state's breaches of its treaty obligations.

Yet, despite the similar treaty language, can the US investor really expect the same level of treatment from an under-resourced country still undergoing a transition to capitalism, like Moldova, that they can expect from a wealthy country like Canada?

Unfortunately for our hypothetical US investor, and foreign investors all over the world, the answer is unclear. A series of recent arbitral decisions interpreting investment treaties have

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[2] The state hosting foreign investment is generally regarded as the "host state."

[3] NAFTA Article 1105(1).

[4] Article 2(3)(a), US-Moldova BIT.

come to conflicting conclusions on the effect of the level of development of the host country on the standard of protection that foreign investors can expect.

Consequently, despite the language of the investment treaties, those investing in developing countries still do not know the level of protection they can expect. They do not know the risks to which they are exposing themselves and therefore their investment's chances of success. This paper examines these conflicting decisions in the light of the origins of the modern standard of protection and the purposes of investment protection treaties to determine whether parties to investment treaties should be held to the same standard of conduct, regardless of their level of development.

II. INVESTMENT TREATY STANDARDS OF PROTECTION AND THE HOST STATE'S LEVEL OF DEVELOPMENT

While provisions vary across international investment treaties, most treaties contain similar substantive protective provisions. These substantive protective provisions can be divided into absolute and relative provisions. Relative provisions offer a standard of protection at least as favorable as that received by others. For example, national treatment provisions promise treatment not less favorable as that provided to locals. Most favored nation provisions promise treatment not less favorable as that provided to foreign investors from any third country.

Of the absolute provisions, many treaties promise "fair and equitable" treatment and "full protection and security."[5] In many treaties, the offer of "fair and equitable" treatment and "full protection and security" is combined with an offer to provide international law standards of protection.[6] For example, Article 2(3)(a) of the US-Moldova BIT says:

> "Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law."

Other treaties offer "fair and equitable treatment" and "full protection and security" on their own. For example, Article 2(2) of the United Kingdom-Albania BIT says:

> "Investments of nationals or companies of each Contracting Party shall at all times be accorded fair and equitable treatment and shall enjoy full protection and security in the territory of the other Contracting Party. ..."

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[5] With regard to the prolificacy of the fair and equitable treatment, see: United Nations Conference on Trade and Development, "Fair and Equitable Treatment," UNCTAD/ITE/IIT/11 (Vol. III) (1999) at 23; with regard to the prolificacy of the full protection and security standard, see: United Nations Conference on Trade and Development, "Bilateral Investment Treaties in the Mid-1990s," UNCTAD/ITE/IIT/7 (1998) at 55.

[6] See, in particular, treaties of the US, Belgium-Luxembourg, France and Switzerland.

Even though treaties might offer these protections without reference to international law standards of treatment, there is broad support for the interpretation that international law standards of treatment still inform their meaning. For example, the OECD explained that the meaning of "fair and equitable," which appears alone in Article 1(1) of their *Draft Convention on the Protection of Foreign Property*, was informed by the international law standard of treatment:

> "The phrase 'fair and equitable,' customary in relevant bilateral agreements, indicates the standard set by international law for the treatment due by each State with regard to the property of foreign nationals. The standard requires that ... protection afforded under the Convention shall be that generally accorded by the Party concerned to its own nationals, but, being set by international law, the standard may be more exacting where rules of national law or national administrative practices fall short of the requirements of international law. The standard required conforms in effect to the 'minimum standard' which forms part of customary international law."[7]

It is important to note, however, that not everyone shares this view. The UNCTAD, for example, has said:

> "... the presence of a provision assuring fair and equitable treatment in an investment instrument does not automatically incorporate the international minimum standard for foreign investors. Where the fair and equitable standard is invoked, the central issue remains simply whether the actions in question are in all the circumstances fair and equitable or unfair and inequitable."[8]

Most treaties also offer some form of protection against expropriation. Often these provisions provide that the host state can only expropriate if they pay appropriate compensation and expropriate in a manner consistent with the international law standard of treatment. For example, Article 3(1) of the US-Moldova BIT says that investments can only be expropriated "in accordance with ... the general principles of treatment provided for in Article 2(3)." Recall that Article 2(3) of that treaty promised treatment in accordance with the international law standard.

The international law standard of treatment therefore provides the heart of foreign investors' protection under international investment treaties. While the meaning of the international law standard of treatment has been refined over the years, its meaning is still

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[7] "OECD Draft Convention on the Protection of Foreign Property," 7 ILM 117 (1968) at page 120. See also the discussion in Stephen Vasciannie, "The fair and equitable treatment standard in international investment law and practice," (2000) 70 *BYIL* 99 from page 139.

[8] UNCTAD (1999), above Note 5 at 40. See also Rudolf Dolzer and Margrete Stevens, "Bilateral Investment Treaties" (Martinus Nijhoff, 1995) at 60; Vasciannie from page 139; F.A. Mann, "British Treaties for the Promotion and Protection of Investments," (1981) *BYIL* 241at 243; *Pope & Talbot, Inc. v. Canada*, Award on the Merits of Phase 2, April 10, 2001at para. 111.

largely uncertain. Even those elements that have been refined, have only been refined to vague sub-standards, allowing substantial room for interpretation by arbitral tribunals. Tribunals are therefore free to consider a variety of factors in determining whether a host state has provided the standard.

The scope for modern investment treaty tribunals to consider a variety of factors is easily seen through the increasingly popular "expectations" test. Under this interpretation of the standard, the host state is obliged to fulfil the investor's legitimate expectations. This interpretation was famously described in the *Tecmed* decision, in which the Tribunal said that the host state is obliged to provide "treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment."[9]

This interpretation has also been applied by the *Metalclad v. Mexico*,[10] *MTD v. Chile,*[11] *Occidental v. Ecuador,*[12] *Generation Ukraine v. Ukraine*[13] and *CMS v. Argentina*[14] Tribunals. None of these decisions indicate that the investor's legitimate expectations are the same in every country in which they invest. The decisions therefore leave room for holding different countries to a different standard. It could easily be argued that the foreign investor's expectations depend on the host state's resources and experience in implementing its policies or, in other words, its level of development. The "expectations" interpretation of the international law standard therefore leaves scope for arbitral tribunals to consider that level of development in determining if the state has failed to provide the international law standard of treatment.

The popular interpretation of the "full protection and security" standard also leaves scope to consider the host state's level of development. Several tribunals have said that the "full protection and security" obligation requires the host state to provide such protection as is

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[9] *Tecnicas Medioambientales Tecmed S.A. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, May 29, 2003.

[10] *Metalclad Corporation v. The United Mexican States,* Award, August 30, 2000, reprinted in 40 ILM 36 (2001) at para. 99.

[11] *MTD Equity Sdn. Bhd. and MTD Chile S.A.v. The Republic of Chile*, ICSID Case No. ARB/01/7, Award, May 21, 2004 at paras. 114-115, 188.

[12] *Occidental Exploration and Production Company v. Republic of Ecuador,* London Court of International Arbitration Case No. UN 3467, Final Award, 1 July 2004 at para. 184.

[13] *Generation Ukraine, Inc. v. Ukraine,* ICSID Case No. ARB/00/9, Award, 16 September 2003 at para. 20.37.

[14] *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award, May 12, 2005 at paras. 278-281.

"reasonable under the circumstances."[15] It could easily be argued that the host state can only reasonably provide the protection that their level of development allows.

Investor-state tribunals therefore have scope to consider the host state's level of development in determining if they have failed to provide the investor with international law standards of treatment. Tribunals disagree over whether they should use this scope to consider such a factor.

III. RECENT INVESTOR-STATE AWARDS CONSIDERING THE HOST STATE'S LEVEL OF DEVELOPMENT

A. Alex Genin v. Estonia

Possibly attracted by the level of protection promised to him in the US-Estonia BIT, the US investor, Mr Genin, invested in Estonia. That treaty promised him, inter alia, "fair and equitable treatment," "full protection and security" and treatment not "less than that required by international law."[16] The treaty also guaranteed him the right to claim compensation before an international tribunal if Estonia failed to provide that level of treatment.

Mr Genin's investment arose directly from Estonia's transition to a market-based economy. As part of its transition, Estonia sold part of its previously government-owned banking sector. Mr Genin's company, EIB, purchased the Koidu branch of Estonian Social Bank. After purchasing the branch, EIB discovered inaccuracies in the balance sheet provided to it before the sale and claimed in Estonia against Bank of Estonia, trustee responsible for Social Bank.

The Bank of Estonia and EIB subsequently entered negotiations about compensating EIB for their damages resulting from the discrepancies. During these negotiations, the Bank of Estonia conducted its annual audit of EIB, and requested EIB to provide information concerning its shareholders. The Bank of Estonia then issued a "Prescription" requiring EIB's shareholders to apply for qualifying holding permits, which would formally entitle the shareholders to hold shares in EIB in accordance with Estonian law.

EIB's shareholders challenged the validity of the Prescription. While this challenge was pending, the Bank of Estonia revoked EIB's banking license because of discrepancies in the share registry and the list of shareholders with the Banking Supervision Department. In the share

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[15] *Ronald Lauder v. Czech Republic*, Final Award, 3 September 2001at para. 308. See also: *Asian Agricultural Products Limited v. Republic of Sri Lanka*, ICSID Case No. ARB/87/3, Award, June 27, 1990, reprinted in 6 ICSID Rev - FILJ 526; and *CME Czech Republic B.V. v. Czech Republic*, Final Award, March 14, 2003 at para. 353. It is important to note that the *AMT v. Zaire* Tribunal appeared not to find room for reasonableness within the test, instead holding the host state to an "obligation of vigilence": *American Manufacturing & Trading v. Republic of Zaire*, ICSID Case No. ARB/93/1, Award, 21 February 1997, reprinted in Yearbook Comm. Arbitration 22 (1997) 60 at para. 38.

[16] Article 2(3)(a), US-Estonia BIT.

registry, EIB listed its major shareholder as Eurocapital Group *Ltd* but the list of shareholders presented to the Banking Supervision Department, for the purposes of obtaining permits to hold shares, recorded Eurocapital Group *Company* as the major shareholder. The amount of shares held by the two companies was identical and, as the Tribunal later commented, "one could have presumed that the two 'Eurocapitals' were, in fact, one and the same."[17]

EIB challenged the validity of the revocation. While these proceedings were pending, a minority shareholder in EIB successfully petitioned a local court to order the liquidation of EIB because their licence had been revoked. EIB's challenge to the revocation of its license was then dismissed because, inter alia, EIB was already in liquidation.

Understandably grieved by this series of events, Mr Genin brought a claim at the ICSID, claiming the Bank of Estonia's actions breached Estonia's obligations under the US-Estonia BIT. Mr Genin claimed, inter alia, that the Bank of Estonia's actions breached Article II(3)(a) of the treaty. The Tribunal accepted that "[w]hile the exact content of this standard [in Article II(3)(a)] is not clear, the Tribunal understands it to require an 'international minimum standard' that is separate from domestic law, but that is, indeed, a <u>minimum</u> standard"[18]

In analyzing the validity of Mr Genin's claim, the Tribunal found the Bank of Estonia's reasons for revoking the licence as "extremely technical,"[19] "exceptionally formalistic," "superficial" and "could not have justified ... the revocation of EIB's licence."[20] The Tribunal went on to say that the process, under which the licence was revoked was "somewhat irregular,"[21] "contrary to generally accepted banking and regulatory practice"[22] and "invites criticism."[23] The Tribunal noted that "[n]o notice was ever transmitted to EIB to warn that its licence was in danger of revocation unless certain corrective measures were taken, and no opportunity was provided to EIB to make representations in that regard."[24]

Despite these shortcomings in the Bank of Estonia's treatment of Mr Genin, the Tribunal found that treatment did not fall short of the standard prescribed in the treaty. The Tribunal was

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[17] *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v The Republic of Estonia*, ICSID Case No. ARB/99/2, Award, June 25, 2001 at para. 359.

[18] *Genin v Estonia* at para. 367 (emphasis in original).

[19] *Genin v Estonia* at para. 361.

[20] *Genin v Estonia* at para. 352.

[21] *Genin v Estonia* at para. 355.

[22] *Genin v Estonia* at para. 364.

[23] *Genin v Estonia* at para. 365.

[24] *Genin v Estonia* at para. 358.

evidently influenced by Mr Genin's own poor behavior. The Tribunal commented that the Bank of Estonia's actions were taken in "a context comprised of serious and entirely reasonable misgivings regarding EIB's management, its operations, its investments and, ultimately, its soundness as a financial institution."[25]

Yet, the Tribunal was also evidently influenced by Estonia's status as a country still trying to transition from communism to a market-based economy. Early in their Award, the Tribunal said that it:

> "... considers it imperative to recall the particular context in which the dispute arose, namely, that of a renascent independent state, coming rapidly to grips with the reality of modern financial, commercial and banking practices and the emergence of state institutions responsible for overseeing and regulating areas of activity perhaps previously unknown. This is the context in which Claimants knowingly chose to invest in Estonian financial institution, EIB."[26]

B. X v. Central European Republic

In *X v. Central European Republic,*[27] the British claimant, Mr X, claimed that the Czech Republic breached its obligations in the UK-Czech BIT by failing to honor its contractual obligations. Mr X and a Czech state enterprise had entered a contract under which they agreed to cooperate towards obtaining a telecommunications licence and the state enterprise agreed not to support anyone else's application for a licence. Mr X claimed that the Czech Republic breached these obligations, and its obligations under the BIT, when it subsequently awarded a telecommunications licence to another foreign investor and not to Mr X.

In the Tribunal's analysis of "the questions of fact and law that are relevant to the determination of the merits of [Mr X's] claim for compensation" it said that it would take "into account the rather special factual background to the dispute."[28] This background included the fact that Mr X may:

> "... not have taken sufficient account that the country was still in a state of transition, in which the Government and public authorities were labouring to develop the newly born

[25] *Genin v Estonia* at para. 361.

[26] *Genin v Estonia* at para. 348.

[27] SCC Case 49/2002, Final Award, reprinted in Stockholm Arbitration Report 2004:1 at 141.

[28] *X v. Central European Republic* at page 155.

democratic system and to create a well-functioning market economy."[29]

The Tribunal eventually dismissed Mr X's claim because he did not have an investment in the Czech Republic that satisfied the definition of that term in the UK-Czech BIT. Significantly, the Tribunal defined an investment as referring to "rights and claims which have a financial value for the holder" and "a claim can normally have a financial value only if it appears to be well-founded or at the very least creates a legitimate expectation of performance in the future."[30] While the Tribunal concluded Mr X did not have legitimate expectations from the nature of the contractual obligations and the paucity of other representations, the Tribunal may have been influenced in their conclusion by the Czech Republic's state of development.

C. Generation Ukraine v. Ukraine

The decision in *Generation Ukraine v. Ukraine* is, perhaps, the starkest recent example of a tribunal incorporating a country's level of development in the standard of protection they are obliged to provide foreigners under an investment treaty. The dispute in that case arose out of the failure of a US company's investment in commercial property in Kyiv. The company claimed local authorities interfered with the realization of the project in a manner which was tantamount to expropriation, in breach of Article 3 of the US-Ukraine BIT. That Article obliges the host state, inter alia, to only expropriate "in accordance with ... the general principles of treatment provided for in Article 2(3)." Article 2(3) provides, inter alia, that "Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law."

While the Tribunal accepted the Claimant "experienced frustration and delay caused by bureaucratic incompetence and recalcitrance" it found that the Ukraine's treatment of the investor met the BIT standard. In reaching this conclusion, the Tribunal said:

> "... it is relevant to consider the vicissitudes of the economy of the state that is host to the investment in determining the investor's legitimate expectations, the protection of which is a major concern of the minimum standards of treatment contained in bilateral investment treaties. The Claimant was attracted to the Ukraine because of the possibility of earning a rate of return on its capital in significant excess to the other investment opportunities in more developed economies. The Claimant thus invested in the Ukraine

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29 *X v. Central European Republic* at page 156.

30 *X v. Central European Republic* at page 158.

on notice of both the prospects and the potential pitfalls."[31]

D. International investment treaty claims and "bad business judgments"

The *Maffezini* and *MTD v. Chile* decisions can be seen to implicitly support considering the host state's level of development. In *Maffezini*, the Tribunal emphasized that "Bilateral Investment Treaties are not insurance policies against bad business judgments."[32] The *MTD v. Chile* Tribunal agreed, saying "[t]he BITs are not an insurance against business risk and the Tribunal considers that the Claimants should bear the consequences of their own actions as experienced businessmen."[33]

Experienced businessmen consider a state's level of development when deciding whether to invest in that state. If international investment treaties are not insurance policies against decisions to invest, regardless of that level of development, then the investor cannot expect to claim under the treaty for actions resulting from that level of development.

Despite the implicit import of the Tribunals' decisions, it is important to note that the host state's level of development did not affect either of the *Maffezini* or *MTD* decisions. The *Maffezini* Tribunal considered the actions of Spain, a developed country. While the *MTD v. Chile* Tribunal did consider the investor's voluntary assumption of risk as a factor mitigating against a damages award, the Tribunal did not consider Chile's standard of development as part of that risk. The Tribunal said: "Their choice of partner, the acceptance of a land valuation based on future assumptions without protecting themselves contractually in case the assumptions would not materialize, including the issuance of the required development permits, are risks that the Claimants took irrespective of Chile's actions."[34]

E. Economic crises: Olguin v. Paraguay *and* CMS v. Argentina

The cases discussed above have addressed the host state's development as it attempts to build its administrative and legal capacities. Such newly developed capacities are fragile and vulnerable during economic crises. Such a weakening administrative and legal system may treat

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[31] *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003 at para. 20.37.

[32] *Maffezini v. Spain*, ICSID Case No. ARB/97/7, Award, November 13, 2000 at para. 64.

[33] *MTD v. Chile* at para. 178, citing *Maffezini* with approval.

[34] *MTD v. Chile* at para. 178.

foreign investors in ways that they perceive to be unfair. In addition to considering claims during the building of those capacities, tribunals are, therefore, also likely to consider claims during their collapse. Indeed, at least two tribunals have considered claims that developing countries breached their obligations in an international investment treaty through conduct during economic crises.

The first was the tribunal hearing the dispute between Olguin and Paraguay. The dispute arose from Mr Olguin's investment in a food manufacturing and distribution company in Paraguay. As part of that investment, Mr Olguin transferred money to La Mercantil bank in Paraguay. In return he received investment instruments called TDIs. At the time Mr Olguin chose to invest, Paraguay was undergoing an economic crisis. Unfortunately for Mr Olguin, the crisis continued to escalate and La Mercantil eventually suspended its operations and stopped honoring payment of the TDIs

Mr Olguin claimed, inter alia, that Paraguay had negligently failed to supervise La Mercantil, in breach of its obligations under the Peru-Paraguay BIT. Mr Olguin relied, inter alia, on Article 4(2) of that treaty which obliges Paraguay to treat foreign investors fairly and equitably.

In assessing the validity of Mr Olguin's claim, the Tribunal found that "Paraguay's general conduct in relation to the operations of La Mercantil was not overly sound," and that "there are serious shortcomings in the Paraguayan legal system and in the functioning of various State agencies."[35] The Tribunal found that "the bankruptcy of La Mercantil ... was the consequence of irregular conduct on the part of its managers, that could have been detected, brought to a halt, and if necessary, sanctioned ..."[36] The Tribunal went on to say:

> "... there were considerable omissions on the part of Paraguay's public bodies, which had the duty to preserve the integrity of that country's financial system, in regard, not only, but especially, to foreign investment. In other words, in the case before us, the government accounting bodies of Paraguay clearly appear to have been negligent in regard to their duties to monitor, supervise, or control the agents of their country's financial market, during the period of time in which the facts arose that led to this dispute."[37]

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[35] *Eudoro Armando Olguin v. Republic of Paraguay*, ICSID Case No. ARB/98/5, Award, July 26, 2001 at para. 65.

[36] *Olguin v Paraguay* at para. 69.

[37] *Olguin v Paraguay* at para. 70.

Despite these observations, the Tribunal found that Paraguay’s conduct did not fall short of the standard of treatment prescribed by the treaty.[38] Just like the *Genin* Tribunal, the *Olguin* Tribunal appear to have been influenced by the state of Paraguay’s economy. The Tribunal said it "feels that prudence would have prompted a foreigner arriving in a country that had suffered severe economic problems to be much more conservative in his investments.”[39]

Tribunals hearing the numerous claims against Argentina are also considering the influence of Argentina’s level of development on the international law standard. The claims arise out of measures taken by Argentina in response to its economic collapse of the late 1990s. The decision just delivered in *CMS v. Argentina* gives us a first look at how the tribunals are addressing the issue.

CMS is a US company, that complained Argentina’s measures breached its obligations in the Argentina-US BIT. CMS is a minority shareholder in the Argentine company, Transportadora de Gas del Norte (TGN). TGN was created as part of the privatization of the Argentine gas industry to transport gas. CMS claimed that the terms of its license, as well as legislation and other instruments, gave TGN the right to tariffs in US dollars and the right to adjust the tariffs in accordance with US inflation. Argentina’s measures removed the right to adjustment and converted the tariffs to pesos. When Argentina abandoned parity with the US dollar, the value of the peso fell substantially and TGN’s tariffs were a fraction of what they expected them to be. CMS claimed, inter alia, that Argentina’s measures breached their obligation in Article 2(2)(a) of the Argentina-US BIT to provide the international law standard of treatment.

In assessing CMS’ claim, the Tribunal accepted that the collapse of Argentina’s economy influenced the standard of treatment it could be expected to provide to foreign investors. The Tribunal said “the Claimant cannot ask to be entirely beyond the reach of the abnormal conditions prompted by the crisis, as this would be unrealistic.”[40] The Tribunal went on to say that it “cannot rule out the argument that a tariff kept and adjusted in dollars might be unrealistic in view of the changing economic realities that have been mentioned.”[41] Finally, the Tribunal reaffirmed the point made by previous tribunals that the treaty did not provide an insurance policy against business risk. The Tribunal said:

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[38] The Tribunal found “there is no rule in the BIT relating to ‘gross omissions’ that would serve as a basis for the Claimant’s cause of action” (*Olguin v. Paraguay* at para. 73).

[39] *Olguin v. Paraguay* at para. 75.

[40] *CMS v. Argentina* at para. 244.

[41] *CMS v. Argentina* at para. 183.

> "The crisis had in itself a severe impact on the Claimant's business, but this aspect must to some extent be attributed to the business risk the Claimant took on when investing in Argentina, this being particularly the case as it related to decrease in demand. Such effects cannot be ignored as if business had continued as usual. Otherwise, both parties would not be sharing some of the costs of the crisis in a reasonable manner and the decision could eventually amount to an insurance policy against business risk, an outcome that, as the Respondent has rightly argued, would not be justified."[42]

After expressing its willingness to adjust the standard to accommodate Argentina's changed circumstances, the tribunal found that Argentina had failed to meet the changed test. The Tribunal found that "even within the context of the Argentine legal framework and the Licence itself, there are ways to take these changes into account without abandoning the legal guarantees offered."[43] The Tribunal went on to say:

> "The Tribunal can therefore conclude that if a rebalance of the contractual commitments was required because of changing economic circumstances and their effect on costs and returns, the mechanisms to meet this objective were available under the law and the License. The necessary adjustments could be accommodated within the structure of the guarantees offered to the Claimant. This approach, in turn, would have made any unilateral determination by the Respondent unnecessary."[44]

The *CMS v. Argentina* Tribunal is, therefore, one of several tribunals that have, either explicitly or implicitly, supported considering the host state's level of development in determining if it has treated the foreign investor consistent with the international law standard. Other tribunals have refused to consider this factor.

F. GAMI v. Mexico

The *GAMI v. Mexico* decision is the most explicit example of a tribunal refusing to consider the host state's level of development in measuring their actions against the international law standard. GAMI Investments is a US company owning shares in GAM, a Mexican company that owned five sugar mills in Mexico. Those mills experienced difficulties during a lean period for the Mexican sugar industry beginning in the late 1990s. In an attempt to address these difficulties, Mexico implemented a number of laws and expropriated several mills, including

[42] *CMS v. Argentina* at para. 248.

[43] *CMS v. Argentina* at para. 183.

[44] *CMS v. Argentina* at para. 238.

three owned by GAM. GAMI Investments claimed Mexico's poor implementation of its laws and the expropriations breached a number of its NAFTA obligations.[45]

While the Tribunal eventually rejected GAMI's claims, it did reject a Mexican defence based on its level of development. After explaining that they had "no mandate to evaluate laws and regulations that predate the decision of a foreigner to invest," the Tribunal said:

> "The duty of NAFTA tribunals is rather to appraise whether and how preexisting laws and regulations are applied to the foreign investor. *It is no excuse that regulation is costly. Nor does a dearth of able administrators or a deficient culture of compliance provide a defence*. Such is the challenge of governance that confronts every country. *Breaches of NAFTA are assuredly not to be excused on the grounds that a government's compliance with its own law may be difficult*. Each NAFTA Party must to the contrary accept liability if its officials fail to implement or implement regulations in a discriminatory or arbitrary fashion."[46]

Decisions finding poorly developed countries failed to provide the standard of treatment required in a BIT can be seen to implicitly support the *GAMI* Tribunal's conclusion. None of the Tribunals finding that Zaire, Sri Lanka, Latvia, Chile and Mexico failed to provide the investor with international law standards of treatment prescribed by an investment treaty considered the host country's stage of development.[47] The decision against Zaire provides particularly strong support because it describes how the state defended their actions through their poor level of development.[48] Indeed, in *AMT v Zaire*, while there is no evidence the Tribunal considered local conditions in finding Zaire failed to provide the standard of treatment prescribed in the BIT, the Tribunal did consider those conditions when reducing the claimant's damages. The Tribunal said it would "take into account the existing conditions of the country."[49] The Tribunal went on to say:

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45 *GAMI Investments, Inc. v. The United Mexican States*, UNCITRAL Rules, Final Award, 15 November 2004 at para. 24.

46 *GAMI Investments v. Mexico* at para. 94 (emphasis added).

47 See *AMT v. Zaire*, *SwemBalt AB v. The Republic of Latvia*, UNCITRAL Rules, Award, 23 October 2000, *MTD v. Chile*, *Tecmed v Mexico*, *Metalclad v Mexico*.

48 In *AMT v. Zaire*, Zaire argued: "No one on earth could ignore the fact that for the past four years, the Republic of Zaire has been going through a most painful and unfortunate period in its history. ... This requires a benevolent and compassionate attention on the part of all our partners, even those who have encountered unfortunate and disastrous consequences, for there was a time when these same persons were enjoying the benefit of the good situation of the State of Zaire" (*AMT v. Zaire* at para. 65).

49 *AMT v. Zaire* at para. 62.

"AMT would have liked to adopt a method of calculating compensation ... practicable in the normal circumstances prevailing in an ideal country where the climate of investment is very stable, such as Switzerland or the Federal Republic of Germany. The Tribunal does not find it possible to accede to this way of evaluating the damages with interests in the circumstances under consideration, in which it is apparent that the situation remains precarious ... the Tribunal will opt for a method that is most plausible and realistic in the circumstances of the case, while rejecting all other methods of assessment which would serve unjustly to enrich an investor who, rightly or wrongly, has chosen to invest in a country such as Zaire, believing that by so doing the investor is constructing a castle in Spain or a Swiss chalet in Germany without any risk, political or even economic or financial or any risk whatsoever."[50]

The decisions described above demonstrate that tribunals considering the standard of protection prescribed in modern international investment treaties disagree over the role of the development of the host country. What, then, is the proper approach? A natural place to look for this answer is to the origins of the standard prescribed by modern international investment treaties and the purpose of investment treaties. Unfortunately, neither provides much direction.

IV. THE ORIGINS OF THE MODERN INVESTMENT TREATY STANDARD OF PROTECTION

The origins of the modern investment treaty standard of protection are too complex to be thoroughly presented in this humble paper. Other papers have admirably traced this history and interested readers are directed to these papers.[51] For the purposes of this paper, we need only draw some key features from these origins.

The standard of protection provided to foreign investors in modern international investment treaties originated in some states' realization, over a century ago, that the standard provided at the time by some foreign countries sometimes fell below that which should be accepted. States consequently supported an international law standard of treatment that all states should provide to foreigners, regardless of their treatment of locals.

Elihu Root's 1910 description of the origins of this standard is often repeated. He said:

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[50] *AMT v. Zaire* at paras. 63-64.

[51] See, for example, J. Thomas, "Reflections on Article 1105 of NAFTA: History, State Practice and the Influence of Commentators," 17(1) *ICSID Review - Foreign Investment Law Journal* 21 (2002); Edwin Borchard, "The 'minimum standard' of the treatment of aliens," 38(4) *Michigan Law Review* (1940) 445; Elihu Root, "The Basis of Protection to Citizens Residing Abroad," 4(3) *The American Journal of International Law* (1910) 517.

> "There is a standard of justice, very simple, very fundamental, and of such general acceptance by all civilized countries as to form a part of the world. The condition upon which any country is entitled to measure the justice due from it to an alien by the justice it accords to its own citizens is that its system of law and administration shall conform to this general standard. If any country's system of law and administration does not conform to that standard, although the people of the country may be content or compelled to live under it, no other country can be compelled to accept it as furnishing a satisfactory measure of treatment of aliens."[52]

The principle that states should be held to an international law standard of treatment developed in contrast to the equality principle. Under this principle, foreigners should be treated no better than locals. This principle is well described by the note of the Mexican Minister of Foreign Affairs, contesting the right of the United States to demand compensation for the agricultural lands of American citizens expropriated by Mexico after 1927. The Minister said that Latin American countries had supported:

> "... the principle of equality between nationals and foreigners, considering that the foreigner who voluntarily moves to a country ... in search of a personal benefit, accepts in advance, together with the advantages which he is going to enjoy, the risks to which he may find himself exposed. It would be unjust that he should aspire to a privileged position safe from any risk, but availing himself, on the other hand, of the effort of the nationals which must be to the benefit of the collectivity."[53]

Supporters of the international law standard of treatment certainly envisaged protecting foreigners from local *custom* that could harm foreigners. For example, in a colorful speech, Lord Palmerston said:

> "We shall be told, perhaps, as we have already been told, that if the people of the country are liable to have heavy stones placed upon their breasts, and police officers to dance upon them; if they are liable to have their heads tied to their knees, and to be left for hours in that state; or to be swung like a pendulum, and to be bastinadoed as they swing, foreigners have no right to be better treated than the natives, and have no business to complain if the same things are practiced upon them. We may be told this, but that is not

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[52] Elihu Root, "The Basis of Protection to Citizens Residing Abroad," 4(3) *The American Journal of International Law* (1910) 517 at pages 521-522.

[53] 32 *American Journal of International Law Supplement* 181-207 (1938) at page 188, cited in Edwin Borchard, "The 'minimum standard' of the treatment of aliens," 38(4) *Michigan Law Review* (1940) 445 at 445.

my opinion, nor do I believe it is the opinion of any reasonable man."[54]

Similarly, in his seminal piece on the issue, Borchard said: "Bad faith, fraud, outrage resulting in injury, cannot be defended on the ground that it is a custom of the country to which nationals must also submit."[55]

While it is, therefore, clear that supporters of the international law standard of treatment certainly envisaged protecting foreigners from local custom that could harm foreigners, it is less clear if supporters of the standard envisaged protecting foreigners from poor treatment resulting from lower levels of development. Some seemed to believe it did not. For example, shortly after the passage cited above, Elihu Root went on to say:

> "It is a practical standard and has regard always to the possibilities of government under existing conditions. The rights of the foreigner vary as the rights of the citizen vary between ordinary and peaceful times and times of disturbance and tumult; between settled and ordinary communities and frontier regions and mining camps."[56]

By accommodating the "possibilities" of government, and the differences between "settled" communities and "frontier regions," Root suggests he understood the standard to accommodate different levels of development. This view still garners support today. For example, Ian Brownlie says:

> "Where a reasonable care or due diligence standard is applicable, then diligentia quam in suis might be employed, and would represent a more sophisticated version of the national treatment principle ... it would allow for the variations in wealth and educational standards between the various states of the world..."[57]

Similarly, James Brierly says the standard is "not an exacting one, nor does it require a uniform degree of governmental efficiency irrespective of circumstances."[58] Thomas also

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[54] Lord Palmerston, in the House of Commons, regarding the *Don Pacifico* case. Cited in Root at 522.

[55] Borchard at 449.

[56] Root at page 523.

[57] Ian Brownlie, Principles of Public International Law (Clarendon Press, Oxford, 6th edition , 2003) at page 504.

[58] James Brierly, The Law of Nations (Oxford University Press, 6th ed., Sir Humphrey Waldock ed. 1963) at 280-81.

supports this view, arguing that the "fair and equitable" and "full protection and security" standards, as informed by the international law standard, have "regard to the law's tolerance for manifold differences in the way in which states organize themselves, *their levels of development*, economic system, culture, and so on ..."[59]

The authors cited above were commenting on states' general responsibility to provide international standards of treatment. This responsibility entails both a responsibility to positively act to provide this standard and a responsibility to avoid omissions that harm foreigners. Commentary on states' specific duty to avoid omissions also supports varying the international standard to account for the host state's level of development. In discussing states' responsibility to provide due diligence to prevent such omissions, Pierre Dupuy has commented that "factors may exist ... which lead to the relaxation and adaption of the application of the minimum standard of behaviour, connected not with the circumstances in which the damage occurred, but with the status of the defendant State itself."[60] Dupuy goes on to say that "the behaviour required from a State whose economic resources supply it with the means to increase the extent of its control cannot be the same as that required from a State whose administration is sparse and relatively ineffective for want of material resources."[61]

After reviewing the views of both Dupuy and other commentators on the standard applicable to states' responsibility to use due diligence, Brian Smith concludes: "... the diligence of the state will be considered in light of its particular capacities and practices."[62] Dupuy's views are also similar to those expressed in the 1961 draft codification of the principles of international law governing state responsibility. The draft was prepared by F.V. Garcia-Amador as Special Rapporteur of the International Law Commission. Article 7(1) of the draft says "The State is responsible for the injuries caused to an alien by illegal acts of individuals ... if the authorities were manifestly negligent in taking the measures which, *in view of the circumstances*, are normally taken to prevent the commission of such acts."[63] Paragraph 2 of the Article goes on to say that "The circumstances mentioned in the foregoing paragraph shall include, in particular, the extent to which the injurious act could have been foreseen and the physical possibility of

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[59] J. Thomas, "Reflections on Article 1105 of NAFTA: History, State Practice and the Influence of Commentators," 17(1) *ICSID Review - Foreign Investment Law Journal* 21(2002) at 28 (emphasis added). See also W. Michael Reisman, "The Regime for Lacunae in the ICSID Choice of Law Provision and the Question of Threshold," 15 *ICSID Review - Foreign Investment Law Journal* 362 (2000) at 367.

[60] Pierre Dupuy, "Due Diligence in the International Law of Liability," in OECD, *Legal Aspects of Transfrontier Pollution* (1977) 369 at 375.

[61] Dupuy at 376.

[62] Brian Smith, *State Responsibility and the Marine Environment* (Clarendon Press, 1988) at 40.

[63] Emphasis added.

preventing its commission *with resources available to the State*."[64]

Other commentators and tribunals disagree that the host state's level of development should influence the standard of treatment they are obliged to provide to foreigners. The umpire hearing the *Montijo* case is a prime example. The umpire heard a claim that Panama failed to provide international standards of treatment by failing to recover the boat called the 'Montijo,' which was stolen from Americans by revolutionaries. In finding that Panama failed to provide the international standard of treatment, the umpire said:

> "... the general government of the Union, through its officers in Panama, failed in its duty to extend to citizens of the United States the protection which, both by the law of nations and by special treaty stipulation, it was bound to afford. It was, in the opinion of the undersigned, the clear duty of the President of Panama, acting as the constitutional agent of the government of the Union, to recover the Montijo from the revolutionists and return her to her owner. It is true that he had not the means of doing so, there being at hand no naval or military force of Columbia sufficient for such a purpose; but this absence of power does not remove the obligation. The first duty of every government is to make itself respected both at home and abroad. *If it promises protection to those whom it consents to admit into its territory, it must find the means of making it effective. If it does not do so, even if by no fault of its own, it must make the only amends in its power, viz, compensate the sufferer.*"[65]

Similarly, in commenting on the international standard, Eagleton said "the regular *or even the utmost activity of the state* may here, as elsewhere, be regarded as insufficient because of the failure of the State to measure up to the international standard."[66]

It is therefore evident that, neither the origins of the international standard, nor the academic interpretations of that standard today, provide much guidance on whether modern investor-state tribunals should consider the host state's level of development when measuring their conduct against the international law standard. The purpose of international investment treaties provides little more.

V. THE PURPOSE OF INTERNATIONAL INVESTMENT TREATIES

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[64] Emphasis added.

[65] *Case of the 'Montijo': Agreement between the United States and Colombia of August 17, 1874* (July 26, 1875) International Arbitrations 1421 at 1444 (emphasis added).

[66] Clyde Eagleton, *The Responsibility of States in International Law* (New York University Press, 1928) at 89-90.

The purpose of investment treaties depends on the individual treaty and it is dangerous to reach general conclusions on the meaning of such treaties based on general purposes. Yet, treaties do tend to have common purposes and it is possible to reach some general conclusions from those purposes.

The common purpose of modern investment treaties between developed and developing countries is well represented in the expressed purpose of the US-Moldova BIT. In his Message transmitting the treaty to the Senate, President Clinton said: "It is designed to encourage economic opportunity-including investment, trade, and growth-in both countries. It will assist Moldova in its transition to a market economy by strengthening the role of the private sector and by encouraging appropriate macroeconomic and structural policies." Similarly, the preamble says: "Recognizing that agreement upon the treatment to be accorded such investment will stimulate the flow of private capital and the economic development of the Parties."

These passages identify several purposes, including encouraging investment, growth and economic development. It is useful to analyze these purposes individually.

Both considering and not considering the host state's level of development helps encourage investment. Applying the same standard, regardless of the host country, helps encourage investment by giving investors predictability. Investors are more likely to invest where they know the standard to which the state will be held and are not guessing how an arbitral tribunal might amend a standard to consider a state's level of development. Conversely, holding a state to a standard they cannot provide does not encourage investment, in the long run. Developing countries constantly paying damages to foreign investors for failing to provide a standard of treatment, that it is impossible for them to provide, are unlikely to renew the treaty when it expires.

Turning next to the purpose of encouraging economic development, applying a strict minimum standard seems to support economic development in developed countries party to an investment treaty. Developed countries are more likely to be investing in developing countries and therefore benefit from the higher standard.

Both interpretations can be seen to fulfil the purpose of encouraging economic development in the developing country. Obviously, constantly paying damages to foreign investors for the state's failure to provide an impossible standard hinders development. Yet, paying such damages will provide the developing country with incentive to raise its standards. A passage in the *Genin* decision helps illustrate this point. After finding the bank had not breached the BIT, the *Genin* Tribunal said: "It is to be hoped, however, that Bank of Estonia will exercise its regulatory and supervisory functions with greater caution regarding procedure in the future."[67] Such hopes are more likely to materialize if Estonia risks breaching its treaty obligations when it does not exercise such caution.

Examining general investment treaty purposes therefore bring us little closer to discovering if tribunals should consider the host state's level of development when applying international standards of treatment. Similar to the origins of the international law standard and the commentary on those origins, general investment treaty purposes support both interpretations.

Specific investment treaty purposes can be more instructive. While it is beyond the scope of this paper to examine the purposes of every investment treaty, a former US investment treaty negotiator's commentary suggests that the US understands tribunals should not consider the host state's level of development when applying the standards prescribed in US investment treaties. In commenting on the US BIT program, Pamela Gann suggested that the treaties provide "a residual, *but absolute minimum*, degree of treaty protection to investments, regardless of possible vagaries in the host Party's national laws and their administration, or of a host party's lapses with respect to treatment of its own nationals and companies."[68]

Both the treaties considered in *Genin* and *Generation Ukraine* were produced under the US BIT program. The decision of the tribunals hearing those cases to consider the host state's level of development therefore appears inconsistent with the US' understanding of the treaties.

VI. CONCLUSION

It is little wonder that modern arbitral tribunals have failed to agree on the degree to which they can consider the host state's level of development when applying the international law standard of treatment. The two sources that should best inform the meaning of the standard - the origins of the standard and the purposes of the treaties in which that standard is now promised - provide little direction.

The issue, therefore, seems ripe for clarification by treaty drafters. The political nature of the issue buttresses this conclusion. During negotiations on future international investment treaties, drafters should clarify whether they understand the international law standard of treatment to be an absolute minimum or whether it is influenced by the host state's level of

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[67] *Genin v Estonia* at para. 372.

[68] Pamela Gann, "The US Bilateral Investment Treaty Program," 21 *Stanford Journal of International Law* 373 (1985) at 389 (emphasis added).

development.

Such clarification in future treaties does not, however, help tribunals considering present treaties. Furthermore, increasing numbers of tribunals are likely to have to confront the issue. The issue will arise naturally as a result of the increasing number of claims under international investment treaties. Furthermore, many of those claims impugn Argentina's emergency measures taken during the recent economic crisis. Argentina has claimed that it was forced to take its measures by the economic emergency - a consequence of Argentina's transition to a market-based economy. Tribunals considering the claims against Argentina will, therefore, implicitly or otherwise, have to consider the impact of Argentina's ability to fulfil its treaty obligations in the wake of its transition to a market-based economy.

The increasing number of tribunals forced to determine whether to consider the host state's level of development leads to two possible outcomes. First, tribunals can continue to address the issue in an ad-hoc manner and produce increasing numbers of conflicting decisions. Second, tribunals can begin to address the issue in a systematic manner and eventually develop a consensus. For the sake of consistency and, therefore, ultimately the survival of the international investment treaty arbitration system, it is hoped that tribunals develop a consensus. What should that consensus be?

A possible solution emerges from the *AMT v. Zaire* decision. Recall that, in that case, the Tribunal considered the US investor's claim that Zaire had breached its BIT obligations through Zairean soldiers looting the investor's property. The Tribunal also considered Zaire's defence that the entire country was in turmoil and, indeed, most other businesses had also been looted. From the report of the decision, the Tribunal did not consider Zaire's situation when finding they had breached their treaty obligations. However, the Tribunal did consider that situation when limiting the damages that AMT recovered. The Tribunal found that the market value of the property was severely diminished by Zaire's precarious situation.

Through their decision, the Tribunal achieved some sort of balance between the different purposes of international investment treaties. The Tribunal encouraged investment by finding Zaire breached the treaty when its conduct fell short of the international standard. Yet, the Tribunal also limited the impact of the decision on Zaire's economic development by limiting the damages it had to pay (although some, such as the dissenting arbitrator, believed they should have limited it even more). While it is unsatisfying to hold developing countries to a standard they cannot achieve, this solution could be the best way to fulfil investment treaty purposes in the short term until treaty drafters can construct a more balanced solution.