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"Efficient Breach" and Economic Analysis of International Investment Law by F. Marrella and I. Marboe

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"Efficient Breach" and Economic Analysis of International Investment Law

by Fabrizio Marrella and Irmgard Marboe[1]

Introduction

The field of economic analysis of law may be traced to works of Bentham[2] and even the Italian Beccaria[3], but finds its current structure with seminal works by Coase[4], Becker[5], Calabresi[6], Posner[7] and, more recently, Cooter & Ulen[8] and Shavell[9].

The law&economics revolution has, so far, very rarely touched international law (and, *a fortiori*, international investment law), perhaps because analysis has focused only on the domestic (and mainly US) context or maybe because of a lack of knowledge of technical international legal mechanisms by his founding fathers. According to two authors, both international lawyers,

> "while Westphalian positivism is state-centric, Law&Economics positivism rests upon methodological individualism. Methodological individualism assumes that each person is in charge of his or her own utility function and is a rational evaluative maximizer…we outline here the argument that transactions in international relations are analogous to transactions in private markets".[10]

Economic analysis may enrich understanding of international law although the exercise is particularly delicate and complex. One method concerns recalling (with care) the classical

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2 J. Bentham, *An Introduction to the Principles of Law and Legislation* (London 1789, rep. New York 1973).

3 C. Beccaria, *Dei delitti e delle pene* 1770, trans. *An Essay on Crime and Punishment* (Albany N.Y., 1872).

4 R. Coase, *The Problem of Social Cost*, Journal of Law and Economics (1960) 1-44.

5 G. Becker, *Crime and Punishment: An Economic Approach*, Journal of Political Economy (1968) 169-217.

6 G. Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (New Haven, Yale UP 1970).

7 R. Posner, *Economic Analysis of Law* (6th ed. New York, Aspen 2003).

8 R. Cooter, T. Ulen, *Law and Economics* (3rd ed., Reading, Mass, Addison-Wesley 2000).

9 S. Shavell, *Foundation of Economic Analysis of Law* (Harvard, Belknap 2004)

10 J. Dunoff, J. Trachtman, *Economic Analysis of International Law*, Yale Journal of International Law (1999) pp. 2. See also J. S. Bandhari, A. Sykes (eds.), *Economic Dimensions of International Law: Comparative and Empirical Perspectives* (1997).

conceptual analogy between treaties and contracts: if economic analysis of law (hereinafter EAL) has not studied in deep the former, it has certainly done it for the latter.

EAL involves the application of the methods of economics to explain the rationale of legal rules and institutions. Concepts such as "efficiency" and "wealth maximization" are frequently used to analyse (or explain) the behaviour of legal actors such as contractors, judges or arbitrators and legislators. The overriding assumption of EAL is that rational behaviour can be formalised in economic terms. Another (implicit) assumption is that legal actors' behaviour is studied through the capitalistic model, no attention is given to other economic models.

Only recently EAL has been introduced to international law. It was not before 2003 that Posner added a section about "Treaties and Other International Agreements" in his "Economic Analysis of Law".[11] This shouldn't be seen as "the economist's claim to be able to discuss fruitfully any and all areas of law",[12] but he wanted to point out that "nations in their relations with each other, whether commercial or non commercial, or even belligerent, behave much like individuals in their commercial relations."[13] He admits that nations differ a great deal, "but so do individuals".[14] Certain aspects of the economics of contracts could, therefore, fruitfully also be applied to treaties.[15]

EAL at first sight seems particularly rewarding with regard to the international law on foreign direct investment. This area of law usually deals with large ventures, infrastructure plans, and other economically important projects. It is therefore tempting to apply some of the principles developed in EAL to the complex legal and economic issues and arising in this context.

The present article will concentrate on the concept of "efficient breach" as developed for the law of contracts and its possible application to the law of remedies in international investment law. Remedies for breaches of obligations between States and foreign investors should not only repair the concrete injury in one particular case, but in view of the general preventive function of law also contribute to the compliance with legal obligations by the investment community as a whole. Their importance for the law of international investments

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[11] Posner, *supra* fn 7, pp. 136.

[12] *Ibid.,* 137.

[13] *Ibid.,* 136.

[14] *Ibid,* 137.

therefore can not be overestimated.[16] Given the relevance of economic considerations and interests in this respect it seems appropriate to analyse more closely to what extent principles from the economic analysis of contract law can be applied to international investment law with its particularity of the investor-State relationship.

1. The link between State contracts and international investment agreements

Often, the legal basis of an international investment operation is a contract between a foreign investor and a host country. Hence, the process of negotiation, conclusion, interpretation, performance, non performance or termination of a State contract is of great relevance to international investment law. Many international investment agreements contain provisions called "umbrella clauses" by which they grant protection for obligations assumed by host countries towards foreign investors.[17] Such clauses concern, *inter alia*, compliance with investment contracts. Hence, a violation of a State contract becomes a violation of the applicable international investment agreement.[18]

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15 For a comprehensive analysis of economic considerations in international trade law see W. F. Schwartz and A. O. Sykes, *The Economic Structure of Renegotiation and Dispute Resolution in the World Trade Organisation*, 31 Journal of Legal Studies (2002) 179.

16 This is why the awarding of damages in a rather overall and estimated manner, based on the tribunal's "discretionary judgement", as it has been practiced for a long time in international arbitrations, is increasingly less acceptable. T. Waelde, *Compensation, Damages and Valuation in International Investment Law*, Report to the ILA Committee on the International Law of Foreign Investment, February 2007, at 10; http://www.ila-hq.org/pdf/Foreign%20Investment/Walde%20and %20Sabahi%20Compensation%20&%20Damages.pdf. The lack of appropriate reasoning of the valuation even may give rise for annulment. M. Ball, *Assessing Damages in Claims by Investors Against States*, 16 ICSID Review – FILJ (2001) 408, 428.

17 See for example the 1994 BIT between Ecuador and the United Kingdom referring to "business concessions conferred by law or under contract, including concession to search for, cultivate, extract or exploit natural resources" (Art.1 (a) (v)) or the 1995 BIT between Canada and the Philippines with reference to "rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources" (Art.1 (f) (vi)). See also Art. 1 (6) (f) of the 1994 Energy Charter Treaty where investment is defined to include "any right conferred by law or contract or by virtue of any licenses and permits granted pursuant to law to undertake any Economic activity in the Energy sector".

18 See C. Schreuer, *Travelling the BIT Route: Of Waiting Periods, Umbrella Clauses and Forks in the Road*, 5 JWIT (2004) no. 2, pp. 231-256 and S. Schwebel, *On Whether the Breach by a State of a Contract with an Alien is a Breach of International Law*, in: *Essays in Honour of Roberto Ago*, (Milan 1987) pp.401-414. Among case law see *CMS v. Argentina*; *Azurix v. Argentina; Siemens v. Argentina* and *Vivendi v. Argentina* at www.worldbank.org/ICSID).

2. Contracts and EAL

In EAL a contract is "a specification of the actions that named parties are supposed to take at various times, often as a function of the conditions that hold. The actions typically pertain to delivery of goods, performance of services and payments of money, and the conditions include uncertain contingencies, past actions of parties and messages sent by them".[19]

A contract is said to be "complete" (or "completely specified") if "the list of conditions on which the actions are based is explicitly exhaustive".[20] However EAL scholars discover – with a certain surprise! – that fully specified contracts are simply impossible (and inefficient). This is a result which is rather elementary for lawyers since there is no such a thing like a "complete" or self sufficient contract.

Thus, briefly speaking, a basic function of contract law is to resolve *incomplete* contracts by filling gaps. According to some EAL scholars, the problem consists of stating the terms that the contracting parties would have agreed to, had they been able to foresee the actual circumstances.[21]

From an international legal perspective, one may say that since all contracts are incomplete, choice of law rules are precisely designed to find *lex contractus*. Hence, there are always default rules applicable to the contract thereby reducing transaction costs for the parties.[22]

Apart from the State contract *per se*, other sources of law of the investment relationship include a bilateral investment agreement concluded between the host and the home country of the investor or any other applicable regional or multilateral treaties. From this perspective one may consider the 1969 Vienna Convention on the Law of Treaties as a system of rules

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[19] S. Shavell, *Foundation of Economic Analysis of Law* (Harvard, Belknap 2004) 291.

[20] *Id.* at 292.

[21] Mainly Shavell, *ibidem*. A partially different perspective is offered by I. Ayres and R. Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 The Yale Law Journal, 1989, at 89 ff.. For a critique see E. A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure?* 112 The Yale Law Journal (2003) at pp. 829 in http://www.yalelawjournal.org/pdf/112-4/PosnerFINAL.pdf (accessed on February 25, 2007).

[22] There is no lawless contracts (*contrats sans loi*) since applicable law may be either of a given country or a-national. Among a vast literature see G. Teubner, *Breaking Frames: The Global Interplay of Legal and Social Systems*, Am. J. Comp. L. (1997) at pp. 149; F. Marrella, *La nuova lex mercatoria. Principi Unidroit ed usi dei contratti del commercio internazionale,* in: F. Galgano

applicable to the BIT, the multilateral agreement (where existing) and customary international law, thereby reducing overall information cost on the applicable law.

The implications for game theory in this field have not yet been thoroughly explored in academic scholarship.[23]

3. On contract formation

According to Shavell one important dimension of the law of contract formation "concerns the ease with which parties can determine whether contracts will be legally recognized".[24] If this happens two benefits follow. First "the parties will be able to benefit without any delay from undertaking value-enhancing activities (such as hiring workers and purchasing materials for construction). Second, because parties can avoid making contracts by not making the sign of agreement that would lead to recognition of a contract, they will not be afraid to engage in search for partners, to seek information about possible contracts, to negotiate about them, for parties will not fear to being said to be in a contract they do not want".[25]

A crucial issue surrounding contract formation concerns legal duties to disclose *information*. EAL reasoning emphasises that the social desirability of disclosure depends on the situation. For example, should an oil company that learns through costly investigation that oil is lying under a parcel of land be required to disclose this information to the seller of the parcel or to the State with which an investment contract will be made? The answer, from an EAL perspective is *perhaps not*. This is because the effect of such a disclosure obligation would be to make oil companies pay a much higher price for parcels of land and thus to discourage expensive investigation of the location of oil.[26] In other words, from an EAL standpoint, here law creates an obstacle to an efficient allocation of resources: the incentive to invest money to find oil and contract for the parcel of land is eliminated by the duty of disclosure. As a result, no

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(ed.), *Trattato di diritto commerciale e di diritto pubblico dell'economia* (v.XXX, Padua, Cedam 2003); and the database directed by prof. K. P. Berger at http://www.tldb.net/.

[23] See for example, R. Craswell, *Contract Law: General Theories*, in: B. Bouckaert and G. De Geest (eds.), *3 Encyclopedia of Law and Economics: The Regulation of Contract* 1 (2000) and Cooter, Mattei, Monateri, Pardolesi, Ulen, *Il mercato delle regole. Analisi economica del diritto civile*, I (Bologna, Il Mulino 2006) at pp. 134.

[24] Shavell, at 295.

[25] *Id*.

[26] Shavell at 333 recalling Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, Journal of Legal Studies (1978) 1-34.

rational agent will look for oil and bargain for the land, the owner of the land will not know about oil and therefore there will be no oil drilling.

Rational businessmen would include in their contract provisions for *efficient breach*. Law and economic theories seek to explain judicial remedies in contract law in terms that encourage efficient breach and deter inefficient breach. They define a "Pareto optimal" situation (Pareto being the name of an economist) when one party is better off and no one is worse off.

4. Enforcement of agreements and efficient breach

In all legal systems, enforcement of contractual agreements is accomplished mainly by requiring the party who commits a breach to pay "damages". Therefore, the requirement to pay damages incites contractual performance, to the benefits of the parties and the whole society. Conversely, damage payments constitute a sort of escape clause that parties can use when contractual performance becomes too difficult. In such a situation, they can breach and pay damages rather than bear very high costs to perform the agreement.

This concept was explained by Posner already in the 1970's:

> "…[i]n some cases a party [to a contract] would be tempted to breach the contract simply because his profit from the breach would exceed his expected profit from completion of the contract. If his profit from breach would also exceed the expected profit to the other party from completion of the contract, and if damages are limited to loss of expected profit, there will be an incentive to commit a breach. There should be."[27]

The central economic concept underlying the entire field of EAL is that of "efficiency". EAL is built over the assumption that legal behaviour can be understood as an attempt to achieve the efficient allocation of scarce resources. A clear example as been offered by Prof. Wells in OGEMID:

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[27] R.Posner, *Economic Analysis of Law* (1972), at 120. Shavell, in this respect, has observed that "the orientation of economic analysis of contractual enforcement, through damage payments for breach, is very different from that of traditional legal analysis. Under the latter, damage payments for breach tend not to be regarded as incentives toward performance or as implicit escape hatches. Damage payments are seen primarily as compensation for harm or as proper desert for the wrong of breaking a promise. It should be added that, under the economic view, breach of a contract should not necessarily be identified with breaking a promise; the contracts that are written are not interpreted as detailed promises that parties truly want to be kept, but rather as incomplete promises that are only rough guides for behaviour, and that the parties do not want to govern when performance would be very difficult". Shavell, *Economic Analysis of Law*, discussion paper no. 283 at http://www.law.harvard.edu/programs/ olin_center/ (visited on February 12, 2007).

> "If an airline has ordered an airplane and before the plane has been completed, the market turns down so much that it doesn't need the plane, it is 'efficient' from an economic point of view to breach the contract. It is a waste of economic resources to complete an unneeded airplane. Cancelling the contract is surely attractive to the buyer, but the main point is that it is attractive to the economy as a whole. This makes it 'efficient' to an economist".

If we apply this concept to international investment law we find, for example, that "if a country contracts for more electric power than it needs, it is 'efficient' to cancel the contracts of unfinished plants. It is a waste of economic resources to complete plants that will not be used."

From this perspective, compensation of damages is to be regarded not in the eyes of the contracting party but of the economic system as a whole. Thus, the amount of compensation should be less than the total loss that would occur if the project to build the electric power plant would be completed. Prof. Waelde, has observed (also in OGEMID) that:

> "one can, for example, interpret the current large-scale coercive renegotiation of oil contract and tax terms as 'economically efficient' as the likelihood and cost of sanctions (e.g. damages awards after protracted, uncertain and costly litigation) are at current oil price levels less costly than complying with contracts negotiated in a low-price period (e.g. the Sakhalin II agreement with Shell)."

Hence, the function of rendering justice takes a new dimension. The judge is responsible of the overall welfare of the system of which he or she is expression. Then he must take decisions which increase welfare and discard those not reaching such a result. As a consequence he should facilitate efficient breach and renegotiation of contracts when the economic conditions are met.

5. Breaches of investment contracts

Louis T. Wells, professor at the Harvard Business School, was one of the first who introduced considerations of EAL in the area of international investment law.[28] He was struck by the large amount an arbitral tribunal had awarded to the claimant in *Kahara Bodas Company (KBC) v. Pertamina and PLN* in 2000,[29] which may have included elements of double counting. The case

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[28] L. T. Wells, *Double Dipping in Arbitration Awards? An Economist Questions Damages Awarded to Karaha Bodas Company in Indonesia*, 19 Arbitration International (2003) 471.

[29] KBC operated as a contractor to Pertamina, the state-owned Indonesia oil Company with authority over geothermal energy, and had agreed on an Energy Sales Contract to sell and deliver electricity up to 400 MW to PLN, the state-owned electricity company, essentially on a take-or-pay basis. *Karaha Bodas Company L.L.C. v. Perusahaan Pertambangan Minyak dan Gas Bumi Negara (Pertamina) and PT. PLN (Persero)*, Final Award of 18 December 2000.

concerned a foreign investment in Indonesia to generate electric power by the development of geothermal sites.[30] As a consequence of the Asian currency crisis and because of a decline in demand Indonesia would not need and could not pay for the contracted amount of electricity. By Presidential Decree, the KBC project was eventually suspended. In the subsequent arbitration proceedings the tribunal awarded Claimant US$111.1 million for lost expenditures and US$150 million for lost profits over the 30 years of the contracts.

According to Wells, the total amount was likely to be excessive. It did, above all, not consider that in a long term contract the net present value (NPV) of the expected future stream of cash flow can not be added to the amount of investment made, as the latter is a prerequisite for the former.[31] Wells criticised the conceptual shortcomings of the application of "*damnum emergens*" and "*lucrum cessans*" in international long term contracts.[32]

Wells points at the various adverse consequences of excessive arbitral awards in the ambit of international investments. One of the serious implications would be that governments would be reluctant to terminate economically useless and wasteful projects. He emphasises:

> "[E]xcessive awards discourage government takings, or breach of contract, when such actions are in fact efficient and thus desirable."[33]

As regards the definition of an "efficient" taking he refers to Richard Posner's "Economic Analysis of Law":

> "[…] 'efficient' from an economic standpoint an equivalent of involuntary, describes a case where honouring the contract would result in a waste of resources, such as the production of unneeded electricity."[34]

Furthermore, Wells underlines the importance of Posner's conclusion concerning the importance of calculating damages appropriately:

> "Notice how careful the law must be not to exceed compensatory damages if it doesn't want to deter efficient breaches."[35]

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30 KBC operated as a contractor to Pertamina, the state-owned Indonesia oil Company with authority over geothermal energy, and had agreed on an Energy Sales Contract to sell and deliver electricity up to 400 MW to PLN, the state-owned electricity company, essentially on a take-or-pay basis.

31 Wells, *supra* fn 28, at 474.

32 *Ibid.*

33 *Ibid.,* at 478.

34 R. Posner, *Economic Analysis of Law* (3rd Ed., Boston 1986) 106-107, referred to by Wells, *ibid.,* at fn 4.

35 Posner, *ibid.,* at 108, Wells, *ibid.,* at fn 23.

Already in the 19th century, Oliver Wendell Holmes has sketched the idea behind this concept, paraphrased by Posner in the following way:

> "[I]t is not the policy of the law to compel adherence to contracts but only to require each party to choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to do so."[36]

This *dictum*, regarded as "overbroad" even by Posner later,[37] points out that in many cases it is uneconomical to induce completion of performance of a contract. Posner illustrates this by the following example:

> "I agree to purchase 100,000 widgets custom ground for use as components in a machine that I manufacture. After I have taken delivery of 10,000, the market for my machine collapses. I promptly notify my supplier that I am terminating the contract, and admit that my termination is a breach. When notified of the termination he has not begun the customs grinding of the other 90,000 widgets, but he informs me that he intends to complete his performance under the contract and bill me accordingly. The custom-ground widgets have no use other than in my machine, and a negligible scrap value. To give the supplier a remedy that induced him to complete the contract after the breach would waste resources." [38]

According to Posner it is important to find a remedy that will make both parties better off.[39] One of the possibilities would be to recur to the principle of mitigation of damages:

> "The law is alert to this danger and, under the doctrine of mitigation of damages, would not give the supplier damages for any costs incurred in continuing production after notice of termination."[40]

Maybe this would have been a solution also for the Indonesian case, too. From the point in time when the Indonesian party notified the investor that it would not be able to perform the contract, the latter should have the duty to avoid further losses to be borne by the party in breach. In ICC award No. 7006, for example, the arbitral tribunal awarded profits only on the basis of an

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[36] Posner, *ibid.,* at 106, as quoted by Wells, *ibid.,* at 178, at fn 23.

[37] R. Posner *Economic Analysis of Law* (6th Ed., New York 2003) 119.

[38] Posner, *ibid.,* at 119.

[39] For an economic theory on default rules in contract law see also I. Ayres and R. Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 The Yale Law Journal (1989) 87.

[40] Posner, *ibid.,* at 119.

income stream of one year beyond the breach considering that damages arising later could have been mitigated.[41]

One must, however, avoid overstraining the concept of mitigation of damages in the present context. In the investor-State relationship, the law and its application have a significant preventive function. If the concept of mitigation of damages were used to a large extent, the legal security and reliability of investment contracts and their protection under international law may suffer. If substantial investments are asked from an investor, there must be a reliable legal framework that guarantees either performance of the contract or payment of damages that encompasses full reparation of the financial injury suffered as a consequence of the unlawful act. This should not be undermined by a too broad application of the duty to mitigate damage after a breach.[42]

Himpurna California v. Persero[43] was a very similar case to the *KBC* case, concerning almost the same type of contracts and facts. The tribunal in this case chose yet another solution. It was seriously concerned about the economically wasteful and even disastrous consequences of the long term contract designed very much in favour of the investor. It observed:

> „In such circumstances, it strikes the Arbitral Tribunal as unacceptable to assess lost profits as though the claimant had an unfettered right to create ever-increasing losses for the State of Indonesia (and its people) by generating energy without any regard to whether or not PLN had any use for it. Even if such a right may be said to derive from explicit contractual terms, the Arbitral Tribunal cannot fail to be struck by the fact that the claimant is seeking to turn the ESC into an astonishing bargain in circumstances when performance of the Contract would be ruinous to the respondent."[44]

The Tribunal made a distinction between lost profits on investments already made (which were considerably larger as compared to the ones ascertained in the *KBC* award) and lost profits on investments not yet made. It did not award the latter, although the investor had the contractual

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[41] ICC Award No. 7006, 18 Yearbook of Commercial Arbitration (1993) 58. See J. Paulsson, *The Expectation Model,* in: Y. Derains and R. Kreindler (ed.), *Evaluation of Damages in International Arbitration* (Paris, ICC Publication June 2006) 57, 75.

[42] See already G. Salvioli, *La responsabilité des Etats et la fixation des dommages et intérêts par les tribunaux internationaux*, 28 RdC (1929) 123, 267; similarly R. Laïs, *Die Rechtsfolgen völkerrechtlicher Delikte* (1928) 93; A. Roth, *Schadensersatz für Verletzungen Privater bei völkerrechtlichen Delikten* (1934) 88; G. Schwarzenberger, *International Law. As Applied by International Tribunals* (1957) 663.

[43] *Himpurna California Energy Ltd. v. P.T. (Persero) Perusahaan Listruik Negara (PLN),* Final Award of 4 May 1999, 25 Yearbook of Commercial Arbitration (2000) 13.

[44] *Ibid.,* at para. 318.

right to build more facilities in order to increase the production of electric power. In the eyes of the Tribunal, to ask for those profits on investment not yet made would amount to an "abuse of rights".[45]

This solution of the *Himpurna* tribunal has been criticized by one arbitrator in his separate statement and by commentators.[46] Other tribunals confronted with the economically detrimental effects of long term contracts for the host States, as, for example, in *CME v. Czech Republic*[47] or in *CMS Gas Transmissions Company v. Argentina*[48] have, however, not been able to develop discernable and comprehensive guidelines, either. The question was simply not taken into account in the process of calculating damages.[49]

Professor Wells, in his analysis of the *KBC* award, makes a proposal with regard to the calculation of damages after a breach of long term investment contracts. He points out:

> "The Indonesian generating facility was, however, not a normal trade transaction; rather it had the characteristics of foreign direct investment."[50]

This highlights the special quality of the dispute. Even if the subject of the dispute appeared to be an ordinary long-term contract between two private law parties, in reality it was not. Like many foreign direct investments, it had special contractual elements, but its special features made the arbitrators refer to it as a "Long Term International Development Agreement" and to the foreign company as "the foreign investor".[51] The special quality of the investor-State relationship, therefore, became evident.

As a consequence, Wells proposes to refer to the "fair market value of the property" as the principle guideline for calculating compensation.[52] This resembles the principles of

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45 *Ibid.,* at para. 318.

46 Statement of Arbitrator Fina, 25 Yearbook of Commercial Arbitration (2000) 108; J. Y. Gotanda, *Recovering Lost Profits in International Disputes*, 36 Georgetown Journal of International Law (2004) 61, 106.

47 *CME Czech Republic B.V. v. Czech Republic*, Final Award on Damages of 14 March 2003, 9 ICSID Reports (2006) 246.

48 *CMS Gas Transmissions Company v. Argentina*, Award of 12 May 2005, 44 ILM (2005) 1205

49 See, for example, arbitrator Brownlie's Separate Opinion on the Issues at the Quantum Phase in *CME Czech Republic B.V. v. Czech Republic*, 9 ICSID Reports (2006) 412, paras. 75 et seq.; see also the discussion of the relevance of the economic crisis in Argentina on the calculation of damages with regard to long term contracts. *CMS Gas Transmissions Company v. Argentina*, *ibid.*, para. 165.

50 Wells, *supra* fn 28, 474-5.

51 See *KBC v. Pertamina and PLN*, *supra* fn 29, at para. 91. Wells, *ibid.,* 476.

52 Wells, *ibid.*

compensation upon expropriation under public international law rather than contract law principles. This is not a coincidence, as will be developed further below.

6. Breaches of investment treaties

With regard to international investment law, the treaties in question are the numerous investment treaties that States in the past decades have concluded in order to promote and protect direct foreign investment. Most of them are bilateral treaties, the so-called BITs, some of them are regional, like the NAFTA and the Energy Charter Treaty.

It is important to point out that the applicable law in case of treaty violations is public international law. The law of contracts only plays a subsidiary role insofar as general principles of law may be rooted in or derived from national contract laws "as recognized by civilized nations" according to Article 38 of the ICJ-Statute. The law of treaties has been codified in the Vienna Convention on the Law of Treaties of 1969 which contains a rather comprehensive set of rules regarding the rights and obligations of States with regard to treaties.

What room is there for an economic theory on treaty law? As it is well known, the regime of the Vienna Convention is rather scarce with regard to remedies. The most important ones are suspension or termination of a treaty on certain serious grounds. The Vienna Convention does not deal with the consequences of a simple breach or non-performance of a treaty obligation. This matter is left to the law of State Responsibility, as codified by the ILC in its Articles on State Responsibility in 2001.

It is, however, true that there is a lack of a strong supranational authority to enforce international laws and norms. The absence of strong supranational enforcement authorities make reputation a very important factor in the honouring of international agreements.[53] And, as Posner emphasises, even in the domestic sphere much contract enforcement is decentralised:

> "Most contracts are complied with not out of fear of legal action but out of concern with reputation and because of the availability of self-help remedies such as repossession and other form of forfeiture and the withholding of reciprocal performance (or payment)."[54]

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[53] Posner, *supra* fn 37, 139.

[54] *Ibid.,* 137.

It seems, therefore, advisable not to disregard the economic implications of compliance or non-compliance with international investment treaties. In many cases the economic analysis will show that compliance is also economically "efficient".

By contrast, it will be more difficult to establish that non compliance is an "economically efficient" option. It would be necessary for the State, on beforehand, to calculate the costs for the breach in order to be able to compare them with the costs for compliance. One must bear in mind that, the State would not only be obliged to pay damages, including consequential damages and also costs. It will probably also have to face other detrimental economic consequences.

This is particularly so because "country risk" plays an important role for international direct investments. For a State that becomes known for breaches of its obligations, this country risk may increase significantly.[55] The "cost" of a treaty breach then will turn out to be much higher than the amount of payable damages or compensation. The State might face a decline in foreign investment, higher political risk rating and thus insurance premiums and a higher threshold hurdle rate of return to compensate for such risk.[56]

In respect of international investment treaties, the calculation of the costs of a treaty breach on beforehand seems to be an almost impossible exercise. The option of an "efficient breach" with regard to the breach of international investment treaties, therefore, does not seem to exist. Economic considerations, like the ones addressed above, must almost inevitably lead to the conclusion that in virtually all cases it is economically more efficient to comply with the treaty than to breach it.

7. Alternatives to deal with economic hardship

In view of the above mentioned shortcomings of "efficient breaches" in the relationship between investors and States, it seems necessary to highlight alternative ways of addressing economically problematic situations and avoiding the waste of resources. They shall be analysed in the following.

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[55] See for a more detailed analysis A. Kolo and T. Waelde, *Renegotiation and Contract Adaptation in International Investment Projects – Applicable Legal Principles and Industry Practices*, 1 JWIT (2000) 5, at pp. 31.

a. Termination and payment of damages

In the example presented by Posner in order to illustrate the main concept of "efficient breach" and the avoidance of a waste of resources,[57] the partner of the breaching party obviously relies on his right to specific performance. Therefore, the contractor in the example might chose to produce the 90,000 widgets and bill the breaching party accordingly.[58]

In the investor-State relationship, by contrast, specific performance seems not to be an available option. In *BP v. Libya*,[59] the investor tried to establish that the revocation of the oil concession was a breach of contract and that that breach could be remedied by an award of the arbitral tribunal to *restitutio in integrum*, thus annulling the revocation and re-establishing the original concession rights of the claimant. The tribunal in this case conducted an extensive analysis of comparative contract law and summarized:

> "Firstly, the principles even of those systems of law which recognise the most far-reaching rights for an innocent party to demand specific performance, are principles of ordinary commercial law. They have been devised, discussed and applied mostly in relation to everyday sale of goods contracts and other transactions of limited duration where, moreover, typically one party performs in kind and the other in money. It is *only by stretching the meanings of legal concepts and general words to the extreme* that these principles can be said to extend to contracts which like the BP Concession still have a term of 40 years to run and which provide for the right to extract and remove natural resources requiring vast fixed industrial installations and presuppose an intimate and complex relationship between the parties.
>
> Secondly, the fact that *the State is the respondent party is one that cannot be overlooked*. Dr. Mitchell, on the basis of a survey of the municipal laws of England, France and the United States, has made it clear that the remedies of specific performance and restitution in kind normally are unavailable against governmental authorities under public contracts."[60]

The Tribunal, therefore, decided that

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[56] See Waelde, *supra* fn 16, 17.

[57] See *supra,* fn 38 and accompanying text.

[58] See *supra,* fn 38.

[59] *BP Exploration Company (Libya) Ltd. v. The Government of the Libyan Arab Republic*, Award of 1 August 1974, 53 ILR (1979) 297.

[60] *Ibid.,* at 439 (emphasises added).

> "the concessionaire is not entitled to call for specific performance by the Government of the agreement and reinstatement of his contractual rights, but his sole remedy is an action for damages."[61]

One can conclude, therefore, that a State that is not in the position to honour the contract may terminate it. The investor will usually not have the right to insist on specific performance. In order to avoid damage to its reputation and image, the State should simultaneously inform the investor about its readiness to pay contract damages according to general principles. These damages would be less than actual contractual performance as they would be limited to reimbursement of costs and an amount for **net** lost profits.

The State, in case of long term contracts, could even apply an appropriate discount factor to the aggregate of the lost profits in order to reflect the time value of money and the risk, including the country risk.[62] This would result in amount significantly lower than paying for the whole contract according to its terms.

b. Expropriation

Another possibility would be to expropriate the contract. It is generally recognized that States may expropriate foreign private property, if it is in public interest, exercised in a non-discriminatory manner, in accordance with due process of law and accompanied by the payment

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61 *Ibid.,* at 354. The innocent party should not have an indefinite unilateral right to terminate the contract at its convenience: "It is therefore not possible to hold that under general principles of law an agreement fundamentally broken or abrogated by one party continues in force and is to be specifically performed indefinitely until the innocent party elects to declare it terminated […]" *Ibid.*, at 352.

62 The tribunal in *Himpurna California v. Persero,* for example, pointed out that the calculation of lost profits must take into account the risk of default, not by intentional breach but by default due to larger forces—political, social, and, in any event, macroeconomic—which *de facto* paralyses contractual performance. It thereby addressed the issue of country risk. It emphasized that, even with absolute obligations to pay, like government bonds, it makes a difference if the issuer is "Switzerland or Swaziland". *Himpurna California Energy Ltd. v. P.T. (Persero) Perusahaan Listruik Negara (PLN),* Final Award of 4 May 1999, 25 Yearbook of Commercial Arbitration (2000) 13, at paras. 358, 364. See I. Marboe, *Compensation and Damages in International Law - The Limits of Fair Market Value*, 7 JWIT (2006) 723, 748.

of compensation.[63] It has equally long been recognized that also contracts represent property rights that may be subject to expropriation.[64]

The practice of international arbitral tribunals confirms that the State enjoys a very large margin of discretion to define what is "in the public interest" as a condition for a lawful expropriation under international law.[65] There seems to be no doubt that the avoidance of economic loss can be accepted as complying with this condition.

If the payment of compensation for a lawful expropriation (usually the fair market value of the expropriated property rights) in the eyes of the host State seems to be more sensible than to perform the contract (or to pay contract damages) it may well opt for a lawful (preferably direct) expropriation.

The fair market value is defined as the "price that a willing buyer would pay to a willing seller".[66] In assessing the fair market value of an asset, a number of objective valuation criteria a reasonable third person would apply have to be considered.[67] It is, therefore, not the subjective estimations and expectations of the investor but the assessments presumably undertaken by reasonable market participants that are determinative. In case of expropriated contracts this means that the fair market value of the contract may not be equivalent to the explicit terms of the contract. Market participants might attach a certain degree of risk to the respective contract, depending, for example, on the affected branch of industry or the country risk.[68] In such a case, the State will be financially better off, if it decides to pay compensation for a lawful expropriation than to comply with the contract on the basis of its terms.

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63 See, for example, M. Shaw *International Law* (2003) 738 with further references.

64 See already the *Norwegian Shipowners' Claim*, Award of 13 October, 1922, 1 RIAA, 307, 334. ("*These contracts were the property* […]". See also R. Higgins, *The Taking of Property by the State: Recent Developments in International Law,* 176 RdC (1982) 263, 271; G. Sacerdoti, *Bilateral Treaties and Multilateral Instruments on Investment Protection,* 269 RdC (1997) 251, 381.

65 See, in particular, the award in *LIAMCO v. Libya*, where the arbitrator even slightly exaggerated by paraphrasing Friedman and holding that each State is free "to judge for itself what it considers useful or necessary for the public good … The object pursued by it s of no concern to third parties…". *LIAMCO v. Libya*, 62 ILR (1982) 141, 194.

66 *Starrett Housing Corp. v. Iran*, Final Award, 16 Iran–U.S. Claims Tribunal Reports (1987) 112, para. 277; see also *Ina Corporation v. Iran*, 8 Iran–U.S. Claims Tribunal Reports (1985) 373, 380; *Phillips Petroleum v. Iran,* 21 Iran–U.S. Claims Tribunal Reports (1989) 79, para. 111.

67 For a more detailed analysis, see Marboe, *supra* fn 62, 735 et seq.

68 This is called the „systematic risk". Marboe, *ibid.,* at 739; see also V. Rajarao, *Determining Damages in Cross-Border Disputes,* in TDM (Provisional, February 2007), at 9, http://www.transnational -dispute-management.com/members/recentlypublished/.

c. Necessity

The serious economic crises in Indonesia and in Argentina in the late 1990es and the respective measures undertaken by the governments have considerably challenged the legal framework for foreign investments and its system of legal protection. In the context of these crises the question has been raised, if a State under serious economic distress can be regarded as being in a state of national emergency or necessity. This would have the consequence that an act of this State otherwise representing a violation of an international obligation would not be regarded as unlawful. According to Article 25 of the ILC's Articles on State Responsibility "necessity" is one of the grounds for precluding the wrongfulness of an otherwise internationally wrongful act.[69]

International practice has recognized that, as a matter of principle, a state of economic emergency may represent a state of national emergency or necessity and therefore constitute a ground for precluding wrongfulness.[70] The ICSID tribunals in *CMS v. Argentina*[71] and *LG&E v. Argentina*[72] have recently reaffirmed that a serious economic crisis in a country may preclude the wrongfulness of the violation of a treaty obligation.[73]

Reliance on necessity is, however, only possible in extraordinary circumstances of economic distress. The measure in question must be the only way for the State to safeguard an essential interest against a grave and imminent peril. It definitely does not represent an available remedy if a contract only is economically inconvenient or wasteful.[74] The right of a State to

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[69] See J. Crawford, The International Law Commission's Articles on State Responsibility. Introduction, Text and Commentary (Cambridge 2002) pp. 178.

[70] *Russian Indemnities Case*, 11 RIAA, 431, 442.

[71] *CMS Gas Transmission Company* v. *The Argentine Republic*, Award of 12 May 2005, 44 I.L.M. 1205 (2005).

[72] *LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc*. v. *The Argentine Republic*, Decision on Liability of 3 October 2006.

[73] Only the criteria for the existence of such a state of necessity and the question on the amount compensation due in such a situation have been analysed differently. For a critique of these inconsistencies see A. Reinisch, *Necessity in International Investment Arbitration - An Unnecessary Split of Opinions in Recent ICSID Cases? Comments on CMS v. Argentina and LG&E v. Argentina,* TDM, Volume 3, Issue 05, December 2006, http://www.transnational-dispute-management.com/members/search/welcome.html.

[74] To comply with the criteria of necessity, the economic crisis must be severe and the State's mere existence must be at stake. See *Gabcíkovo-Nagymaros Project (Hungary v. Slovakia),* I.C.J. Reports 1997, 7, para. 55

invoke necessity in extreme cases of economic crises can be seen as a recompense for the State's lacking possibility to liberate itself from its obligations by bankruptcy and liquidation. These are options that only private parties have at their disposal.[75]

d. Renegotiation

Renegotiation of contracts represents one of the most important mechanisms in EAL, according to Shavell for the following reason:

> "If contracts will be renegotiated when difficulties arise, then performance of contracts will occur whenever this would be mutually beneficial, despite the incompleteness of contracts".[76]

In international investment law, renegotiation appears to be an appropriate tool for avoiding the waste of economic resources. As Kolo and Waelde already have pointed out:

> "The long-term nature of the contracts at issue makes them vulnerable to disruption from unforeseen events or events which the parties – for whatever reason – did not, and perhaps could not, deal with in the contract with sufficient time and in sufficient detail."[77]

The authors emphasise that there exist a number of reasons for both the government and the investor for renegotiation, if an agreement turns out to be economically wasteful or useless. Governments often have asked for renegotiation when external events have disrupted the original equilibrium or when companies have made a much higher return form an operation due to external events.[78] Companies, on the other hand, wanted to renegotiate when the imposition of obligations became much more onerous than originally envisaged so that the minimum financial return from the project could no longer be realised.[79]

These incentives for renegotiation are reinforced by the above mentioned possibilities of a State to abrogate from original contractual or treaty obligations in its legal relations with an investor. In the relationship between an investor and a State, the latter party has a stronger legal

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75 For a further analysis of this unequal position with regard to loan agreements see T. Waelde, *The Serbian Loans Case: A Precedent for Investment Treaty Protection of Foreign Debt?* in: T. Weiler (ed.), *International Investment Law and Arbitration* (London 2005) 383 at 385.

76 Shavell, *Foundations of Economic Analysis of Law*, 366-367.

77 Kolo and Waelde, *supra* fn 55, at 5.

78 *Ibid.,* at 30.

79 *Ibid.,* at 31.

position than the former. This remains true even if the balance in economic strength may sometimes be different. The inequality of available legal instruments is characteristic and an important distinction from a contract between two private parties.

The investor, therefore, is well advised to first enter into renegotiations, if the deal turns out to be economically useless or wasteful. In the area of international direct investment, comparable business opportunities normally are not easy to find. This is particularly so in the field of exploitation of natural resources, but it is also true in other areas.

Economic principles of the investor-State relationship might, therefore, be helpful in order to find sensible solutions, advantageous to both parties, after an agreement has resulted to cause economic hardship and/or waste of resources.

Conclusion

So far, the sophisticated academic debate in EAL is capable to offer new explanations of the rationale of some investment rules. It not only has an impact on the law of contracts but also enriches the analysis of the relationship between investors and States in the area of international investments.

However, the concept of "efficient breach" remains to be difficult to adapt to this specific relationship. This is due to the unequal legal and factual position of one of the two parties. A State has more and better options than to "breach" an agreement with the investor. A breach of an international obligation would, furthermore, cost a State probably much more than a private contractor, because of the effects of his reputation to economic parameters affecting its entire national economy. The "breach" of an obligation by a State towards an investor can therefore, also from an economic point of view, hardly be recommended.

The foreign investor may not easily find it economically "efficient" to breach his or her obligations, either. In most cases, renegotiations would almost inevitably lead to more efficient solutions. This is, among other things, due to the fact that business opportunities in the area of foreign direct investment are not easily interchangeable, unlike in international trade. Furthermore, the considerable expenses normally spent on international investments projects, the convergence of financial and personal capacities involved, and the litigation costs have to be taken into account. Thus, the breach of an investment agreement by the investor does normally not turn out to be economically "efficient".