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Contractual Renegotiations and International Investment Arbitration

A Relational Contract Theory Interpretation of Investment Treaties

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ABSTRACT

The relationship between international investment treaties and the underlying contracts remains a highly disputed matter in international investment law. This project explores the contract-treaty interaction by using the renegotiation of regulatory contracts in the sector of energy infrastructure as a natural experiment, with a particular emphasis on the arbitral disputes that arose from the Argentine crisis. It deploys to this end an original analytical framework drawing from transaction cost economics and relational contract theory. The result of the novel combination of these two analytical frameworks is the construction of an interpretative methodology that takes an integrated approach to the two instruments – the contract and the overarching treaty – in a way that achieves a more sustainable balance between the competing public and private interests.

In particular, the thesis rests on three arguments: the first is the relational-contract nature of dynamic treaty standards, which require the long-term cooperation of the parties. The second is the status of these vague standards as default rules complemented by the provisions of the underlying contracts, which are also relational, and act as gap-fillers. The last, normative argument is that the relationship between these (default) treaty rules and the (gap-filling) contractual provisions should be determined by transaction cost economics, and specifically the goal of economizing on the transaction costs of bounded rationality and opportunism when and interpreting relational treaty standards.

The relational contract theory interpretation of investment-treaty standards, namely the standard of fair and equitable treatment, has evident policy implications for the reform of the investor-state dispute settlement system and the future of international investment relations. Applying the principles and tools of relational contract theory to the interpretation of these standards would bring more consistency and pragmatism to the adjudication of disputes arising from the renegotiation of regulatory contracts. More importantly, it would be a powerful law-and-economics tool to achieve the alignment of the parties' incentives both during the dispute and, in a backward induction, the implementation of their contract. Forcing the parties' cooperation and contributing to the success of their concession and thus the ensuing development of a host state are long-neglected priorities of international investment law, which shall form part, though, of the mission of international investment arbitration as global governance.

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1. Renegotiating in the shadow of investment treaties: the inherent dilemma between commitment and flexibility

Few issues have stirred more debate in international investment law than the inherent dilemma between commitment and flexibility, or otherwise the need, on the one hand, to renegotiate complex, long-term contracts between a state and a foreign investor, and the counterbalancing force of the stability of their contractual relationship. The most acute expression of this delicate trade-off are disputes arising from the renegotiation of regulatory contracts, particularly as a result of hardship that a state faces in times of a severe economic crisis.

The Argentine crisis has been a telling example of such a "natural experiment", which led to several arbitral awards addressing the issue of the renegotiation of the disputed concession contracts in very different ways. In this adversary context, the investor-state dispute settlement system has often fallen victim of all types of extremes: hailed by some as a neutral international mechanism for the de-politicization of disputes between states and foreign investors (the good-arbitrators scenario); vilified by others as a machine for the corporate usurpation of democratic accountability (the bad-arbitrators scenario), or taking the middle-ground that arbitrators are inevitably faced with sensitive dilemmas placing them in a difficult position to make hard policy choices ("the ugly truth" scenario).

None of these extremes has managed to capture the essence and utility of international investment arbitration. The investor-state dispute settlement can be a useful mechanism for a "fair and equitable" resolution of international investment disputes, but this can only materialize should the system remedy the institutional and interpretative failures that it has suffered so far. In this context, several remedies have been proposed both on the procedural side (such as a multilateral investment court) and the substantive side (such as the public-comparative-law approach to treaty interpretation). This thesis focuses on failures in the legal reasoning of arbitral tribunals that have impeded them from realizing their full potential as an independent and de-politicized dispute-resolution mechanism.

To this end, the main argument made herein is that, what has been predominantly missing from the resolution of investor-state disputes, thus creating an imbalance between the rights of these parties under international law often giving rise to the so-called -

“legitimacy crisis” of investment arbitration, is a legal-realist approach to treaty interpretation drawing from the school of “new institutional economics”, and particularly transaction cost economics.

Unlike most dissertations in law, the starting point of, and inspiration for, the present research has been a problem entirely based on economics and identified through an economic analysis of the perverse phenomenon of contractual renegotiations in the sector of concessions for the development of energy infrastructure. It is this analysis that inspired the identification of the gap in the legal literature regarding the way that contractual renegotiations have been treated under international investment law, and particularly at the final - and most crucial (both in terms of damages and reputation) - stage of investor-state dispute settlement.

The present research aims to bridge this gap between law and economics, or “law on paper” and “law in action” by bridging the gap between a distinctly economics problem, the renegotiation of regulatory contracts, on the one hand, and the (so far) inconsistent legal responses that investment-treaty tribunals have given to this problem, on the other. Using an original analytical framework combining transaction cost economics and its contract-law counterpart, relational contract theory, it aims to guide arbitrators faced with thorny interpretative tasks, when deciding whether the renegotiation of a concession contract constitutes a breach of the treaty under the ambit of which these contracts are implemented.

To this end, this thesis proposes a “governance design” for the interpretation of investment treaties, focusing on their most contentious provision, the standard of “fair and equitable treatment”, when its breach is claimed on the basis of the renegotiation of a concession contract between a state and a foreign investor. Borrowing the term from transaction cost economics, “governance design” means the matching of transactions with the appropriate governance structures in a discriminating way. “Design” in this context means that the following parts addressing the nature of concession contracts, the interrelationship between the underlying contract and the overarching treaty, and the application of relational contract principles for the interpretation of investment treaties, are interdependent. This means that it is the relational character of the underlying concession contracts that dictates the application of relational contract principles for interpreting the overarching treaty standards (especially FET), when their breach is claimed as a result of the collapse of the contract (due to its renegotiation).

The purpose of putting in place the proper interpretative design connecting the treaty with the underlying contract, is to economize on the transaction costs involved in the relevant

unit of analysis.[1] Concession contracts being the unit of analysis herein, the argument promoted herein is that arbitration, as global governance, needs to be subjected to certain structural disciplines, in order to address the transaction costs prevalent in this type of contractual transactions, namely the costs of "bounded rationality" and "opportunism".

"Bounded rationality" and "opportunism" are the two behavioral assumptions which transaction cost analysis relies on, and which add realism to the study of transactions and the organization of economic activity, thus reflecting the tradition of legal realism. "Bounded rationality" means that human actors are described as "intendedly rational but only limitedly so." [2] As *Williamson* notes, for transaction cost economics purposes, the key ramification of bounded rationality for the study of contract is that "all complex contracts are unavoidably incomplete." [3]

Bounded rationality alone would not have prohibited comprehensive contracting, had it not been coupled with "opportunism". As opposed to simple self-interest that classical economics assume, "opportunism" is the pursuit of self-interest with guile (what is known in the insurance literature as "adverse selection" in the case of *ex ante* opportunism, and "moral hazard" for opportunism manifested *ex post*).[4]

These two behavioral assumptions combined, summarize the problem of economic organization: "devise contract and governance structures that have the purpose and effect of economizing on bounded rationality while simultaneously safeguarding transactions against the hazards of opportunism". The problem of managing these two transaction costs is exacerbated by failures in enforcing competition in the case of natural monopolies, as the sector of energy infrastructure is. Even when competition "for" the market, through competitive bidding, works *ex ante*, the parties' contractual relationship experiences a "fundamental transformation" into a condition of "bilateral dependency",[5] once the concession is awarded and the disciplining force of competition is no longer in place.

Applying the above logic of transaction cost economics to international investment law, this thesis argues that concession contracts between states and foreign investors are relational contracts, and consequently, international investment arbitration, as a form of governance, has to be adjusted to match the attributes of these contracts in order to

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[1] Williamson, O. (1981), The Economics of Organization: The Transaction Cost Approach, American Journal of Sociology, 87 (3): 548, at 548: "Economizing is accomplished by assigning transactions to governance structures in a discriminating way."
[2] Simon, H. (1957), *Models of Man*, John Wiley & Sons, New York, at 24.
[3] Williamson, O. (2007), *Transaction Cost Economics: An Introduction*, Retrieved from: www.economics-ejournal.org/economics/discussionpapers/2007-3/at_download/file, at 9
[4] Williamson, O. (1985), The Economic Institutions of Capitalism, Firms, Markets, Relational Contracting, The Free Press, A Division of Macmillan, Inc., at 47.
[5] Id., at xiii, 301.

economize on the bounded rationality and opportunism of the parties both during the phase of the treaty dispute and, in a backward induction, the implementation of their contract.

The main attribute of concession contracts, as complex, long-term, relational agreements, is their need for adaptation, as circumstances changes or new information becomes available. In this evolving context, the proper structure for the governance of concession contracts, including the adjudication of disputes ensuing therein, is a type of "adaptive governance" that fosters the alignment of the parties' incentives and their cooperation in the long run in order to implement such necessary adaptations.

To this end, arbitration, as a form of global governance, has a decisive role to play for the success of concession contracts and the ensuing development of the economy of the host state. Such role requires, though, a change in the legal reasoning of arbitrators and structural set-up of the system that would mark a shift from a purely adversary mechanism awarding damages to investors, once their contractual relationship with the host state has collapsed, to a wider governance mechanism that facilitates the adaptation and salvation of the parties' relationship in order to avoid its collapse.

As aforementioned, the "natural experiment" best positioned to implement this novel governance structure based on relational contract theory and guided by the policy goals of transaction cost economics, are the treaty disputes ensuing from the renegotiation of concession contracts. In addition to conceptualizing an analytical framework for the interpretation of the "fair and equitable treatment" standard, this thesis moves on to proposing also concrete legal mechanisms, operational within the existing system, which would implement this novel governance design for the interpretation of investment treaties.

To this end, the design of the governance structure for the adjudication of treaty disputes arising from the renegotiation of concession contracts proceeds as follows: the first chapter focuses on the "attributes of transactions", that is, the main characteristics of concession contracts and the acuteness of the transaction costs of bounded rationality and opportunism arising from their implementation. The conclusion ensuing from the examination of these characteristics is that concession contacts are complex, long-term, relational contracts calling for the design of an "adaptive governance" for their implementation, part of which is their (often inevitable) renegotiation in order to adjust to the changing circumstances.

The second chapter moves a step closer to the world of treaties under the ambit of which concession contracts are awarded and implemented. The argument herein is that any interpretation of investment treaties establishing their "clinical isolation" from the

underlying contracts only perpetuates the inequality of arms between states and foreign investors resorting to arbitration. On the contrary, arbitral tribunals have to take into account the underlying contractual realities when interpreting FET, in case an investor claims a breach of the standard on the basis of a renegotiation of the underlying concession contract.

In other words, it is not only investment treaties that have an impact on investment contracts (namely by leading to their internationalization), but the influence is mutual: the relational nature of the disputed concession contracts and the ensuing need for their adaptation has (and should have) an impact on the way that investment-treaty standards are interpreted. In addition to arguing for the interconnection between the contract and the treaty, thus "bridging the contract-treaty divide",[6] the second chapter also aims to operationalize this contract-treaty interaction by identifying concrete "contact points" between the two instruments. Among such "contact points" are the doctrine of "legitimate expectations", the "umbrella clauses", and the application of the UNIDROIT Principles of International Commercial Contracts – an instrument originally destined for commercial contracts – to the adjudication of treaty standards.

Having made the connection between the contract and the treaty, the third chapter refocuses the attention to the attributes of the concession contracts and their specific effect on the interpretation of the disputed treaty standards, namely FET. To this end, it starts with the argumentation for the application of contract theory to the interpretation of international treaties, and proceeds with the argument that relational contract theory, in particular, is the appropriate interpretative framework for investment treaties, at least for disputes arising from the renegotiation of relational, concession contracts.

What makes relational contract theory particularly promising for bringing more balance between (the often conflicting) public and private interests is its potential for serving the policy goals of economizing on the transaction costs of bounded rationality and opportunism. Such economization would foster the alignment of the parties' incentives thus forcing them to cooperate in order to implement the necessary adaptations to their contractual relationship, instead of letting the contract collapse and resorting to arbitration for the award of damages (with the ensuing risk of making arbitration an insurance mechanism fostering moral hazard).

As with previous chapters, the purpose of the third chapter is two-fold: complete the normative argument for the application of relational contract theory to the interpretation of investment treaties, and build on existing case-law on the legal responses that arbitral

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[6] Sinclair, A. (2009), Bridging the Contract/Treaty Divide, in: Binder, C. et al. (Eds), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer*, Oxford Scholarship Online, at 92.

tribunals have given to the issue of contractual renegotiations, and the allegedly ensuing breach of FET. To this end, the examination, in the fourth chapter, of the arbitral awards resulting from the Argentine economic crisis shows the divergence in the legal reasoning and interpretative approaches of tribunals in addressing the question whether a contractual renegotiation constituted a treaty breach. Whereas some tribunals have taken a rigid, textualist approach akin to classical contract law, others have adopted a reasoning closer to the tenets of relational contract theory, operationalized herein by the interpretative proxies of "mutuality" and "dynamism".

The governance design concludes with the proposal of certain necessary supplements to interpretation, that is, tools relating to evidence and the necessity for making all material information available to the tribunal, in order to allow for the most informed interpretation of FET. In this context, the fifth chapter places particular emphasis on the potential of adverse inferences and penalty default rules for the disclosure and verifiability of material information to the tribunal, and their importance for alleviating information asymmetries between the parties, thus forcing a better alignment of their incentives.

In a similar vein as the previous chapters, the fifth chapter also takes both a normative and a positive-law approach to evidence by examining, on the one hand, the actual use of adverse inferences by arbitral tribunals, and designing, on the other, penalty default rules for forcing the disclosure of evidence. Last, the chapter explores also the role that mediation could have for reforming the current investor-state dispute settlement system, and in particular the use of mediation as a mechanism for conducting a de-politicized and fair and equitable renegotiation process, which would allow for the gathering and placing of evidence to the disposal of a subsequent arbitral tribunal judging the compatibility of such process with the treaty.

Before moving to the elaboration of the aforementioned "governance design" for the interpretation of FET, it is useful to set the background against which such governance would take place, namely the complex balance between public and private interests that concession contracts, as public-private partnerships aim to achieve. It is equally relevant to explain why this thesis is particularly novel and timely, as promoting a long-needed legal reasoning for arbitral tribunals judging the most contentious standard of FET, thus setting a new framework for balancing public with private in international investment arbitration.

The timeliness and utility of public-private partnerships in infrastructure is indisputable, as was demonstrated, among others, by the recent crises that even states with advanced economies suffered, thus making it particularly difficult for the state to assume the role of the exclusive financier of vital investments for the development of its energy

infrastructure. The instances of private participation in public services and the importance of arbitration for disputes ensuing therein are too many to cite, but a case in point has been Egypt's recent bid to expand its renewable energy sector, and the financing difficulties that the government encountered in its attempt to exclude international arbitration from its proposed contract terms for the power purchase agreement.[7] Moreover, the model of public delegation by concession contract remains valid as ever, as demonstrates, for example, the establishment of concession agreements for the development of energy infrastructure of the "Eastern Partnership" countries.[8]

2. Defining Public-Private Partnerships in Infrastructure: A Complex Balance between Conflicting Interests

The division between the public and private domains has long proved to be mostly artificial. The neoliberal[9] movement, often summarized as the "Washington Consensus", marked the massive privatizations of the 1990s and assigned a new management role to the state, signaling the transition from an era of "government" to an age of "governance".

The "governance" model of the state denotes a network of relationships between public and private actors that negotiate over policy-making processes and their enforcement.[10] In this "New Public Management" scheme, the emphasis shifts from the traditional public administration and command-and-control regulation[11] to decentralized public management and the increased use of competition and market forces for the provision of public services.[12]

A characteristic manifestation of this new governance model for the public sector has been the formation of "public-private partnerships". As the term indicates, public-private

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[7]www.iarbafrica.com/news-list/201-egypt-includes- mandatory-arbitration-in-cairo-in-ppa-agreements; www.thenational.ae/business/energy/egypts-renewable-energy-sector-faces-delay-to-funding. See also http://globalarbitrationreview.com/chapter/1145229/construction-arbitration-and-concession-contracts

[8]https://ec.europa.eu/energy/sites/ener/files/documents/agenda_17th_mtg_eap_platform_3_23june_2017_final.pdf

[9] The term "neoliberalism" is used here in a descriptive manner, without a pejorative or another connotation, as sometimes implied. Alternative terms are those of "market reforms", "free market policies", "monetarism", or "economic liberalism". See French, J.D. & Lymburner, M., (2012), *Neoliberalism*, Retrieved from Oxford Bibliographies.

[10] Freeman, J., (2000), *The Private Role in Public Governance*, New York University Law Review, 75(3): 543

[11] Lobel, O., (2005), *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, Minnesota Law Review, 89: 342, at 300.

[12] Larbi, G., (1999), *The New Public Management Approach and Crisis States*, Retrieved from: United Nations Research Institute for Social Development website: http://www.unrisd.org/80256B3C005BCCF9/(httpAuxPages)/5F280B19C6125F4380256B6600448FDB/$file/dp112.pdf

partnerships (herein, PPPs) lie in the intersection between public and private and call for the continuous collaboration of the two spheres with a view to achieving a shared goal. Also known as partial privatization,[13] PPPs are a popular governance structure for the delivery of public infrastructure or public services, but also a hybrid organizational form presenting distinct challenges for the sustainable relationship between the state and the private partner. The focus is on PPPs for the development of infrastructure,[14] particularly in the energy sector and the provision of basic public goods to a country's population.

The research question that the present dissertation addresses is the evaluation of contractual renegotiations by arbitral tribunals adjudicating a treaty claim, namely a claim of the breach of the "fair and equitable treatment" standard as a result of the renegotiation of a concession contract between the host state and the foreign investor. The main argument underpinning this thesis is that, despite the internationalization of these contracts (as covered by international investment treaties), the way their renegotiation has been adjudicated is uneven for the contractual parties from the perspective of international law and for achieving a fair and transparent distribution of the renegotiation surplus between them.

More specifically, despite the nature of these contracts as international agreements, and the crucial importance of renegotiation as a mechanism for their long-term governance and success, international law has been mute in addressing the renegotiation process in its entirety and in order to facilitate the adaptation of the contractual relationship and strike a fair balance between the public and the private interests.

The need for a continuous equilibrium between the different interests of the host state and the foreign investor is particularly salient in the case of PPPs. PPPs are a form of partial privatization, which means that the umbilical cord between the government and the firm has not been severed. Despite the variance in types, PPPs in energy infrastructure present certain common characteristics. These are the long-term relationship between the state and the investor, a whole-life approach to the cost of the project, and the allocation and sharing of risks between the two partners.[15]

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[13] Partial privatization is the delegation of a production activity to the private sector, while the government retains the responsibility for the final accomplishment of the relevant public function. Savas, E.S., (2005), *Privatization in the City: Successes, Failures, Lessons*, Washington, DC: CQ Press, at 17.

[14] The sectors of the economy traditionally falling under the domain of infrastructure are water and sanitation, energy, telecommunications, and transportation. See Sawant, R.J., (2010), *Infrastructure Investing: Managing Risks and Rewards for Pensions, Insurance Companies & Endowments*, New Jersey: Jon Wiley & Sons, Inc.

[15] World Bank (2009), *Good governance in public-private partnerships : a resource guide for practitioners*, Retrieved from: http://documents.worldbank.org/curated/en/2009/06/16465546/good-governance-public-private-partnerships-resource-guide-practitioners, at 9.

Unlike full privatization, whereby the ownership of state assets is transferred to the private sector, partial privatization is a form of privatization by delegation. In this type of private participation in infrastructure, the ownership of the assets as well as the ultimate responsibility and accountability for the provision of the public service and the monitoring of its operation remains with the government.[16] For its part, the private investor assumes significant operational, financing, and investment responsibilities, and (at least part of) the commercial risk of service provision.

This delicate allocation of risks and responsibilities leads to a continuous interdependence of the two partners, leaving ample room for a complex set of problems, particularly the hazard of a long-term misalignment of the incentives and the interests of the two parties, or on the other hand, their potential collusion to the detriment of consumers and taxpayers.[17]

There is a continuum of delegation options, ranging from the weakest form of private involvement by means of management and lease contracts[18] to the strongest versions of PPPs through concession contracts and joint ventures.[19] The focus herein is on the governance and adjudication of concession contracts, because of their particular characteristics and the ensuing challenges they present for the enduring governance of PPPs, in particular in the sector of energy infrastructure.

Using the language of transaction cost economics,[20] concession contracts constitute a hybrid form of industrial organization, lying at the intersection between markets and hierarchies.[21] While management and lease contracts are regular procurement contracts

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[16] Or the contract provides for the transfer of the assets to the government at the end of the concession period. See Guislain, P. & Kerf, M. (1995), *Concessions - The Way to Privatize Infrastructure Sector Monopolies*, Retrieved from: http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/059guislain.pdf

[17] Lopez de Silanes, F. & Chong, A. (2003) *The Truth about Privatization in Latin America*, Retrieved from: http://www.iadb.org/res/publications/pubfiles/pubr-486.pdf, at 35.

[18] Management contracts are short-term agreements that assign to the private party the performance of specific tasks in exchange for a fixed fee paid by the awarding authority. See PPPIRC World Bank, Public-Private Partnership in Infrastructure Resource Centre, *Management/Operation and Maintenance Contracts*, Retrieved from: http://ppppirc.worldbank.org/public-private-partnership/agreements/management-and-operating-contracts. In the case of lease contracts, the private operator assumes further responsibilities of operating and maintaining the utility, but not of financing the investment, which remains the responsibility of the public authority. See also PPPIRC World Bank, *Leases and Affermage Contracts*, Retrieved from: http://ppppirc.worldbank.org/public-private-partnership/agreements/leases-and-affermage-contracts

[19] PPPIRC World Bank, *PPP Arrangements/Types of Public-Private Partnership Agreements*, Retrieved from: http://ppppirc.worldbank.org/public-private-partnership/agreements

[20] As will be explained further in the following section, Transaction Cost Economics is the analytical framework for the development of the research question of this thesis, and also the driver for the policy recommendations relating to the sustainable governance of infrastructure PPPs.

[21] Williamson, O. (1992), *Markets, hierarchies and the modern corporation, An unfolding perspective*, Journal of Economic Behavior and Organization, 17 (3): 335, at 336, and Williamson, O. (2005), *The*

operating at the market level[22] and joint ventures are integrated corporate entities owned jointly by the state and the private investor (the so-called institutional PPPs), concession contracts belong to neither markets nor hierarchies, but bear a complex, hybrid set of characteristics from both realms. On the one hand, they are contracts open to competitive, market bidding for their award,[23] while on the other hand their long-term nature and strong public-interest externalities resulting from their performance establish the need for their hierarchical regulation by a public entity.

Given the monopolistic nature of infrastructure industries, the regulation of their operation is the main force to prevent monopoly abuses by the concessionaire and the main mechanism for balancing the interests of the state (including its interest, as an alleged agent of the citizens, to protect the consumers of the utility services)[24] with the legitimate interest of the concessionaire to make a fair profit on its investment. However, regulation suffers itself from inefficiencies, particularly those resulting from information asymmetries between the public trusteeship and the regulated firms[25] or from the potential capture of the regulator by the industry.[26]

Economics of Governance, Retrieved from: http://laisumedu.org/DESIN_Ibarra/desin/pdf-seminario2006/seminario-2006-04c.pdf

[22] The simpler structure of this type of PPP contracts does not mean that they do not also present challenges for their management and monitoring. See Ménard, C. (2013), Is Public-Private Partnership Obsolete? Assessing the Obstacles and Shortcomings of PPP, Ménard, C. (2013), *Is Public-Private Partnership Obsolete? Assessing the Obstacles and Shortcomings of PPP*, in: de Vries, P. & Yehoue, E. (Eds.), The Routledge Companion to Public-Private Partnerships, London: Routledge, at 149 - 175: "even with contracts of relatively limited impact, for example when key rights remain controlled by public authorities as with management or service contracts, monitoring arrangements might face serious difficulties […]"

[23] Competitive bidding is the most common method (and probably the most efficient too) for the award of concession contracts. See Saussier, S. (2003*), Contractual Arrangements and the Provision of Public Interest Services: A Transaction Cost Analysis*, European Business Organization Law Review, 4 (3): 403, at 410, 411. See also Woodhouse, E. (2005), *A Political Economy of International Infrastructure Contracting: Lessons from the IPP Experience*, Retrieved from: http://iis-db.stanford.edu/pubs/20990/PESD_IPP_Study,_Global_Report.pdf, at 65-66: "negotiations suffer from informational asymmetries and mixed incentives. Direct negotiation intrinsically suffers from low levels of transparency […]".

[24] This thesis does not rely on a narrow (and naïve) assumption that the state acts always as a benevolent agent for the people; on the contrary it takes account of the probability of opportunistic behavior by the government and of the tenets of the public choice theory. See Buchanan, J. (2003), *Public Choice: The Origins and Development of a Research Program,* Retrieved from: http://www.gmu.edu/centers/publicchoice/pdf%20links/Booklet.pdf, at 7: "The rent-seeking subprogram remains active along several dimensions. How much value, in the aggregate, is dissipated through efforts to use political agency for essentially private profit? How can the activity of rent-seeking, as aimed to secure discriminatory private gains, be properly distinguished from the activity aimed to further genuinely shared "public" interests"?

[25] Brousseau, E. & Glachant, J.M. (2004), The economics of contracts and the renewal of economics, in: E. Brousseau & M. Glachant (Eds), The Economics of Contracts, Theory and Applications, Cambridge University Press, at 19. See also Laffont, J. & Tirole, J. (1993), A Theory of Incentives in Procurement and Regulation, Cambridge MA: MIT Press

[26] Guasch, J.L. (2004), *Granting and Renegotiating Infrastructure Concessions, Doing it Right*, WBI Development Studies, Washington, DC: World Bank, Retrieved from:

Inefficient regulation has created the need for more competition.[27] Nevertheless, competition in the market is impractical in the case of monopolistic sectors, as network industries are.[28] In this context, competitive bidding for the award of concession contracts (or in other words, competition "for" the market) arises as a potential protection against the market power of incumbents.

In its turn, competitive bidding also presents challenges relating both to the design of the auction process[29] and the design of the contract itself, particularly its service

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https://openknowledge.worldbank.org/handle/10986/15024, at 8:" Governments are not the only parties who may behave opportunistically. Once a private enterprise has been granted a concession in an infrastructure sector, it may be able to "hold up" the government - for example by […] using regulatory capture. An enterprise's extensive information advantages over government (and, in most cases, over other potential operators) and perceived leverage in negotiations can give it strong incentives to renegotiate a contract and secure a better deal than the original bid. The resulting regulatory arrangements may be less effective in protecting customers from monopoly abuses". See also Andres, L.A, Guasch, J.L. & Straub, S. (2007), *Does Regulation and Institutional Design Matter for Infrastructure Sector Performance?,* Policy Research Working Paper; No. 4378. World Bank, Washington, DC, at 7-8: "For the sample of companies covered in this study […] the quality of regulation is not overall very high. […] few countries have consistently applied all of the design principles needed to ensure good quality regulation". On regulatory capture, see also Gómez-Ibáñez, J. (2006), *Regulating Infrastructure, Monopoly, Contracts, and Discretion*, Harvard University Press. The problem of regulatory capture is also well-established in theory. See Laffont, J.-J. & Tirole, J. (1991), *The Politics of Government Decision-Making, A Theory of Regulatory Capture*, The Quarterly Journal of Economics, 106 (4): 1089. The authors explain the function of a regulatory agent from the perspective of the "capture" or "interest group" theory, which emphasizes the role of interest groups in the formation of public policy, in line with Marx's, Stigler's and Olson's theory of collective action. See also Buchanan, J., *supra* note 24, as well as Buchanan, J. (1965), *An Economic Theory of Clubs*, Economica, New Series, 32 (125):1.

[27] See Brousseau, E. & Glachant, J.M., *supra* note 25, at 19.

[28] Competition in the market is inefficient (i.e. a waste of society's resources) in the case of natural monopolies, as network industries are. See Klein, M. (1996), *Competition in Network Industries,* Retrieved from: http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-1591, at 3-4. See also Klein, M. & Gray, P. (1997), *Competition in Network Industries – Where and How to Introduce It,* Retrieved from: http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/104klein.pdf. See also Bennett, M. & Waddams Price, C. (2004), *Incentive Contracts in Utility Regulation,* in: E. Brousseau & M. Glachant (Eds.), *supra* note 25, at 417.

[29] OECD Observer Policy Brief (2007), *Competition Policy and Concessions*, Retrieved from: http://www.oecd.org/regreform/sectors/38706036.pdf. For more details on the difficulties of a competitive bidding process, particularly the uncertainty with regard to the appropriate bidding criteria and the hazard of adverse selection, as well as the risk of collusive agreements among bidders, see Saussier, S. (2012), *An Economic Analysis of the Closure of Markets and other Dysfunctions in the Awarding of Concession Contracts,* Retrieved from: http://www.europarl.europa.eu/document/activities/cont/201206/20120626ATT47715/20120626ATT47715EN.pdf. See also Søreide, T. (2012), *Risk of Corruption and Collusion in the Awarding of Concession Contracts,* Retrieved from: http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL-IMCO_NT%20(2012)%20475127, and Williamson, O. (1989), *Transaction Cost Economics*, Handbook of Industrial Organization, 1: 135, at 144, as well as Estache, A., Guasch, J.L., Iimi, A. & Trujillo, L. (2009), *Multidimensionality and Renegotiation: Evidence from Transport-Sector Public-Private-Partnership Transactions in Latin America,* Review of Industrial Organization, 35: 41.

specifications.[30] In the final analysis, no matter how successfully an auction has been conducted, empirical evidence shows that the renegotiation of concession contracts is a pervasive phenomenon.[31] Therefore, the public partner must ultimately contract efficiently with service providers in a bilateral-monopoly situation.[32] The reality of contractual renegotiations is also recognized academically, particularly in the theory of incomplete contracts.

In this environment of contractual renegotiations, the emphasis shifts from regulation and competitive bidding to the *ex post*, implementation phase, in other words, the "governance" of the contract. The contractual transaction becomes the main unit of the analysis[33] and the contract arises as a tool of coordination, the flexibility and adaptability of which are central to the sustainable governance of the PPP relationship.

The complexity of the governance of concession contracts and their renegotiation is exacerbated when the concession is controlled by a multinational corporation (herein, MNC), incorporated in a foreign state, and thus subject to different market pressures for the maximization of its shareholders' returns.[34] The difference in the business conduct of MNCs as concessionaires compared to domestic investors is also attested empirically. For example, *Post* (2014) finds that domestic concessionaires that had maintained "relational contracts" – meaning contracts that involve renegotiation in the face of unforeseen circumstances - with the host governments, were better able to keep bargaining relationships alive during economically and politically turbulent times. On the contrary,

[30] Klein, M. (1998), *Bidding for Concessions, The Impact of Contract Design*, Retrieved from: http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/158klein.pdf

[31] See *supra* Saussier, S., at 5: "all concession contracts need to be renegotiated. […] empirical studies suggest that concession contracts are very often, if not always, renegotiated […] Renegotiations are the rule, not the exception […] there is no point establishing rigid rules for award procedures […] because actors anticipate that such are generally renegotiated ex post. Rigidifying renegotiations ex post would not be a solution either. It would bind partners in bad deals when contracts are misaligned with their environment, as would invariably occur (because they are incomplete long-term agreements).

[32] In Williamson's terms, this bilateral-monopoly situation might result from the "fundamental transformation" of the relationship from an ex ante competitive one to an ex post monopolistic one. Such transformation arises in conditions of asset specificity. See Williamson, O., *supra* note 29, at 145: "a condition of large numbers bidding at the outset does not necessarily imply that a large numbers bidding condition will obtain thereafter. Whether ex post competition is fully efficacious or not depends on whether the good or service in question is supported by durable investments in transaction specific human or physical assets. […] The reason why significant reliance investments in durable, transaction specific assets introduce contractual asymmetry between the winning bidder on the one hand and non-winners on the other is because economic values would be sacrificed if the ongoing supply relation were to be terminated. Faceless contracting is thereby supplanted by contracting in which the pairwise identity of the parties matters."

[33] As opposed to the whole market or the industry.

[34] See, *inter alia*, Cohen, S. (2007), *Multinational Corporations and Foreign Direct Investment, Avoiding Simplicity, Embracing Complexity,* Oxford University Press.

MNCs would typically request the cancellation of the contract and resort to international arbitration.[35]

The literature on the power of MNCs is considerable. For the purposes of the present research it suffices to note that, despite the transnational operation of MNCs, they remain highly unregulated by international law, with the burden of their regulation falling on the host states. This gap in international regulation of MNCs has led to several initiatives, often led by the so-called "international civil society" (particularly NGOs) or international organizations, like UNCTAD, for the development of norms for the operation of MNCs, including those forming the agenda of the so-called "international corporate social responsibility".[36]

The focus of this thesis is on the norms produced by a particular mechanism crafted for the protection of MNCs and other international investors, when a PPP relationship collapses: the mechanism of international arbitration. The main argument is that international arbitration (and also, mediation) has been an underutilized mechanism for the sustainable governance of international investment contracts. This reality runs counter both to its role as a form of global governance and an emerging field of global administrative law, and to the tenets of the economic theory on the governance and adjudication of incomplete contracts - as concession contracts are.

3. The Need for the Renegotiation and Adaptation of Concession Contracts

Empirical evidence shows an excessively high incidence of renegotiations of concession contracts. According to *Guasch* (2004), in an examination of a database of more than 1000 concessions during the period 1985-2000 in Latin America and the Caribbean, 55 percent of the transportation contracts were found to have been renegotiated. The phenomenon has been even more perverse in the water and sanitation sectors, with renegotiations occurring therein in 74 percent of concessions. Renegotiation is defined as

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[35] Post, A. (2014), *Foreign and Domestic Investment in Argentina, The Politics of Privatized Infrastructure,* Cambridge University Press.

[36] Muchlinski, P. (2007), *Multinational Enterprises & the Law*, Oxford University Press, at 83-89 and Muchlinski, P. (2007), *Regulating Multinationals: Foreign Investment, Development, and the Balance of Corporate and Home Country Rights and Responsibilities in a Globalized World*, Retrieved from: http://www.law.yale.edu/documents/pdf/Alumni_Affairs/Andrea_Bjorklund_readings.pdf. See also Cohen, S. (2007), *supra* note 34. On the problem of transfer pricing, see OECD Guidelines for Multinational Enterprises (2008), Retrieved from: http://www.oecd.org/corporate/mne/1922428.pdf, and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), Retrieved from: http://www.oecd-ilibrary.org/docserver/download/2310091e.pdf?expires=1417638762&id=id&accname=ocid195467&checksum=DB2075F327F3C0369675B75FDD9D3AD0. On the critique of NGOs against MNCs, especially as providers of basic goods, like water, see for example, Friends of the Earth (2001), *Dirty Water, The environmental and social records of four multinational water companies*, Retrieved from: https://www.foe.co.uk/sites/default/files/downloads/dirty_water.pdf

a material change[37] in the terms[38] of the original contract, which is not the result of contingencies spelled-out in the contract. In other words, it is a radical revision of the concession contract, not provided for in any (renegotiation, adjustment, or other) clauses of the contract itself. Even more alarmingly, in the cases examined, renegotiation took place very soon after the award of the contract, on average just 1.6 years in the water and sanitation sectors.[39] Also, on average, the outcome of renegotiations favored the operators and affected adversely the users, as they resulted in delays in investment obligation targets, tariff increases (including increase in the number of cost components automatically passed-through to consumers), reduction of investment obligations, and extensions of the concession period.[40]

The above empirical studies add an alternative perspective to the issue of contractual renegotiations and challenge the theory of obsolescing bargain and the related hold-up problems for investors, as established in the traditional literature on foreign direct investment. According to the conventional wisdom of obsolescing bargaining, the negotiating leverage in a large infrastructure project shifts during its life cycle: the position of the initially weaker host state, in need of foreign capital, is reinforced after the investment is sunk, and thus the investor finds herself in a more vulnerable position facing the risk of expropriation (or creeping expropriation).[41]

Counter to these mainstream predictions, *Guasch* (2004) shows that the party initiating the renegotiation and requesting the modification of the terms of the contract has more often been the private investor rather than the host government.[42] This finding turns the hold-up argument on its head, since the concessionaires are shown to have achieved renegotiations leading to better terms for themselves after sinking their investments and thus becoming supposedly more vulnerable due to the *ex post* immobility of their sunk assets.[43]

The traditional obsolescing bargain theory as applied to the relationship between a foreign investor and the host state is also challenged by the current structure of the

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[37] Council Directive 2014/23/EU on the award of concession contracts (2014) OJ L94/1, pp. 14, 41.
[38] Particularly in tariffs and annual fees, investment plans, guarantees, service standards, and concession periods. See *supra* Guasch, J.L. (2004), at 12.
[39] Id., at 34, 13. See also Guasch, J.L, Laffont, J-J & Straub, S. (2008), Renegotiation of Concession Contracts in Latin America, Evidence from the water and transport sectors, Utilities Policy, 17 (2): 185, at 421-442.
[40] See *supra* Guasch, J.L. (2004), at 12,18.
[41] Woodhouse, E. (2006), *The obsolescing bargain redux? Foreign Investment in the Electric Power Sector in Developing Countries*, Retrieved from: http://nyujilp.org/wp-content/uploads/2013/02/38.1_2-Woodhouse.pdf, at 127
[42] See *supra* Guasch, J.L. (2004), at 15-16: "In 61 percent of cases, concessionaires requested renegotiation, and in 26 percent of the cases, the government initiated renegotiation […]"
[43] Engel, E., Fischer, E. & Galetovic, A. (2006), *Renegotiation without hold-up: Anticipating Spending and Infrastructure Concessions,* Retrieved from: http://www.nber.org/papers/w12399

international BIT system. The modern BIT regime is based on a two-tier, multi-party bargaining process. Tier-1 bargain takes place among states, which negotiate the macro rules on FDI, while tier-2 micro negotiations are conducted between the foreign investor and the host state under the shadow of tier-1 rules.[44] This two-level game has important implications for the nature of concession contracts as internationalized state contracts,[45] as analyzed in the second chapter.

Irrespective of the substantive outcome of renegotiations, the renegotiation process itself can also undermine the efficiency of competitive bidding and overall welfare, since it takes place between the government and the operator only, and is thus not subject to the competitive pressures of the auction process.[46] Also, the high number of renegotiations points to opportunism as a plausible explanation for the behavior of the parties, the concessionaire and the host state.[47] The problem is more acute in concessions awarded in "developing" countries, where the imperfect enforcement of contracts and their renegotiation are major issues.[48]

The main question arising in this context is two-fold: first, what are the determinants (or drivers) of such renegotiations, and second, what are the rules and enforcement mechanisms that can ensure the compliance of the parties with their agreement and restrict their incentives to behave opportunistically in order to shift the contractual risk allocation and capture the surplus produced by the renegotiation of their original contract?

The drivers of renegotiation are several and diverse, ranging from exogenous determinants, such as a weak regulatory and institutional environment of the host state (including high levels of corruption, low levels of enforcement of regulatory contracts, or the weak bargaining position of the regulator) or macroeconomic shocks, to endogenous determinants (i.e. clauses embedded in the contract), like the distribution of risks between

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[44] Ramamurti, R. (2001), *The Obsolescing "Bargaining Model"? MNC - Host Developing Country Relations Revisited*, Journal of International Business Studies, 32 (1): 23.

[45] Voss, J.O. (2011), *The Impact of Investment Treaties on Contracts Between Host States and Foreign Investors,* Brill.

[46] Id., at 33.

[47] Guasch, J.L., Laffont, J-J. & Straub, S. (2003), *Renegotiation of Concession Contracts in Latin America*, Policy Research Working Paper; No. 3011. World Bank, Washington, DC, Retrieved from: https://openknowledge.worldbank.org/handle/10986/18224, at 3.

[48] Guasch, J.L & Straub, S. (2006), *Renegotiation of Infrastructure Concessions: An Overview*, Annals of Public and Cooperative Economics, 77 (4): 479. This is not to say that renegotiation is not a significant concern also in countries with more developed institutions. See Oliveira Cruz, C. & Marques, R.C (2013), *Endogenous Determinants for Renegotiating Concessions: Evidence from Local Infrastructures*, Local Government Studies, 39 (3): 352, at 353: "Recently, in May 2011, the UK government announced the intention of renegotiating 150 schools PFI contracts signed by local authorities, and establish common frameworks to develop these schemes, since the heterogeneity among contracts was not having good results. These renegotiations often entail large costs for both users and local governments […]"

the partners or clauses for restoring the financial equilibrium of the concession. Most of these determinants are well identified and documented in the PPP literature.

A variable that remains underexplored, though – despite its crucial importance for the FDI regime and its viability – is the impact of international arbitration on the renegotiation of international concession contracts. According to the above empirical study,[49] arbitration, as a variable, correlates positively with the probability of renegotiation, since the arbitration process helps settle disputes, thus making renegotiation less costly. This result holds for firm-led renegotiations.[50] On the contrary, arbitration correlates negatively with government-led renegotiations.[51] This prediction is in line with the logic of international arbitration as a mechanism to protect investors by preventing government-led renegotiations and securing the predictability and stability of the foreign investment regime.[52]

The above differing effect that arbitration has on the parties' incentives to renegotiate is an issue that has remained highly unaddressed in international investment law. This thesis aims to address this potential imbalance in the incentives that arbitration creates for the PPP parties to renegotiate their contract. More specifically, the goal herein is dual: On the one hand, to examine, from a *de lege lata* perspective, the way that arbitral tribunals have evaluated a claim for a breach of FET ensuing from a contractual renegotiation, and on the other hand, to propose normative recommendations for achieving a better alignment of the parties' incentives to renegotiate and a fairer distribution of the renegotiation surplus.

Before expanding on the research question, it is important to connect the above empirical findings with the theoretical underpinnings of the necessity for the renegotiation of PPP contracts. This necessity emanates from the nature of concession contracts as inherently incomplete. A contract is incomplete when the exact nature of the good or service to be provided is uncertain at the time the contract is drafted, being contingent on a state of nature that is yet to materialize.[53]

As the theory of transaction cost economics predicts, it is prohibitively costly for the parties to write a contingent contract, when the number of unforeseen contingencies is large or it is too costly to acquire and process *ex ante* all the relevant information, or there

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[49] See *supra* Guasch, J.L. (2004), at 88.
[50] Id., at 76.
[51] Guasch, J.L., Laffont, J-J & Straub, S. (2007), *Concessions of Infrastructure in Latin America: Government-led Renegotiation*, Journal of Applied Econometrics, 22 (7): 1267, at 1286.
[52] See Woodhouse, E. *supra* note 35, at 130-131, 181. See also Wells, L. (2005), *The New International Property Rights: Can the Foreign Investor Rely on Them?*, in: Moran, T. & West, G. (Eds), *International Political Risk Management, Looking to the Future*, Washington, DC: The World Bank, at 90-91.
[53] Hart, O. & Moore, J. (1999), *Foundations of Incomplete Contracts*, Review of Economic Studies, 66 (1): 115, at 115.

are information asymmetries[54] between the parties. Another aspect of contractual incompleteness is the difficulty of verifying complicated states of the world (like the effort exercised by the concessionaire or the efficiency of its service) to third parties, particularly the courts; the problem of verifiability leads to higher enforcement costs.[55]

Concession contracts are inherently incomplete, like all complex, long-term contracts. This is because it is impossible, in complex industries like the infrastructure sector and for projects usually running for a period of thirty years or more, to provide for all conceivable eventualities or to preclude economic or commercial surprises.[56] Given this uncertainty, the review and modification of PPP contracts becomes a necessity. To quote *Llewellyn* (1931) on the role of contract in the social order: "One turns from contemplation of the work of contract as from the experience of Greek tragedy. Life struggling against form, or through form to its will - "pity and terror." Law means so pitifully little to life. Life is so terrifyingly dependent on the law." [57]

From a legal viewpoint, there are no rules allowing contracting parties to bar out-of-contract renegotiations.[58] This reality can be explained by bounded rationality. In a complex business environment, administering not only contingencies and contractual provisions, but also the formal communication between the parties may be too costly. Thus, the parties may prefer not to stipulate the renegotiation game directly into the *ex-ante* contract, but leave instead the option of renegotiation open through *ex post* "informal communication".[59] Inherent incompleteness ties up with the rationale of relational contracting, as will be developed further in the first chapter.

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[54] In the case of information asymmetry, apart from the potential problem of non-verifiability of an event to a third-party, the event is also non-observable by one of the contracting parties. See Hart, O. & Moore, J. (1988), *Incomplete Contracts and Renegotiation*, Econometrica, 56 (4): 755, at 756.

[55] Lind, H. & Nyström, J. (2007), *"Observable" and "verifiable": Can these be the basic concepts in incomplete contract theory?*, Retrieved from: http://www.researchgate.net/publication/242679683_Observable_and_verifiable_Can_these_be_the_basic_concepts_in_incomplete_contract_theory

[56] Stern, J. (2012), *The relationship between regulation and contracts in infrastructure industries: Regulation as ordered renegotiation*, Regulation and Governance, 6 (4): 474, at 475.

[57] Llewellyn, K. (1931), *What price contract? An Essay in Perspective*, The Yale Law Journal, 40(5): 704, at 751. See also Salacuse, J. (2001), *Renegotiating Existing Agreements: How to Deal with "Life Struggling Against Form*", Negotiation Journal, 17 (4): 311, at 312.

[58] Baird, D., Gertner, R. & Picker, R. (1994), *Game Theory and the Law*, Harvard University Press, at 117-118: "The possibility of renegotiation undermines the contractor's incentives. The contractor will work less hard than it should because, even if the government has the right to cancel the contract, it will never be in its interest to do so. Instead, the government will renegotiate. An incentive contract that can be renegotiated cannot work as well as one that cannot be renegotiated. Writing such a contract, however, is difficult. […] There is no simple way around this inability to commit to no renegotiation. Our entire legal system would have to change dramatically in order to use legal rules to make contracts non-negotiable."

[59] Segal, I. (1999), *Complexity and Renegotiation: A Foundation of Incomplete Contracts*, Review of Economic Studies, 66 (1): 57, at 74.

Another possible mechanism for the modification of PPP contracts (apart from modification provisions incorporated in the contract itself) is modification through regulation, as a form of "ordered renegotiation".[60] The responsibility for such modifications is most of the times assigned to an independent, national regulator charged with periodic or extraordinary reviews of the PPP contract. However, regulation operates at the domestic level, and it also suffers from several inefficiencies, including the *de facto* lack of independence of the regulator, often attested in practice.[61]

Thus, the focus of this thesis is on the way renegotiation has been dealt with in "international law", and more specifically, by international arbitral tribunals. The regulation of renegotiation only under domestic law, without a similar regulation under international law, is an ineffective means of addressing the transaction costs of bounded rationality and opportunism, as a disconnection between the two systems, the contract and the treaty - or the domestic law and international law - entails the (*de facto*) annulment of any legal effects that the regulation of renegotiation may have had at the domestic level.

On the contrary, what is needed in this context is a holistic perspective of renegotiation as a central legal matter in international investment arbitration. This is the gap that this research aims to fill by arguing for a governance design that allows for the connection between the contract and the treaty and the consideration of contractual renegotiations as a legal (and not merely factual) matter during the adjudication of treaty disputes. The purpose, in other words, is the design of governance structures in investment arbitration that facilitate the adaptation of the underlying contract through good-faith renegotiations as well as the gathering of evidence making verifiable to the tribunal material information relating to such renegotiations.

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[60] See *supra* Stern, J. *supra* note 56.

[61] On the theory of regulatory capture, see Stigler, G. (1971), *The Theory of Economic Regulation*, Retrieved from: http://www.ppge.ufrgs.br/GIACOMO/arquivos/regulacao2/stigler-1971.pdf, as well as Peltzman, S. (1976), *Toward a More General Theory of Regulation*, Retrieved from: http://www.nber.org/papers/w0133. See also Spiller, P. (1990), *Politicians, Interest Groups and Regulators: A Multiple-Principals Agency Theory of Regulation, or "Let Them Be Bribed",* Journal of Law and Economics, 33 (1): 65. Regulators can not only be captured by the industry they are meant to regulate, but also bypassed by politicians, in which case the regulatory process is overtly re-politicized. The *Aguas Argentinas* dispute is one case where such politicization took place. It is important to note that such politicization occurred not only in the final renegotiations, triggered by the major economic crisis that Argentina suffered, but also during the regular course of the concession. See *Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A v. The Argentine Republic*, ICSID Case No. ARB/3/19, Award, 30 July 2010, pp. 16-17.

4. The Research Question: Are Contractual Renegotiations a Breach of the Fair and Equitable Treatment Standard?

a) Presentation of the Research Question

Within the wider *problématique* of treaty claims resulting from the renegotiation of a concession contract, the focus herein is on the most contentious, recent, and widely used standard which foreign investors have based their claims upon: the “fair and equitable treatment” standard. The argument made herein is that international law has failed to address in a balanced (otherwise, “fair and equitable” way) the problem of contractual renegotiations, and this failure has led to the increase of the transaction costs of bounded rationality and, mainly, opportunism.

In the shadow of investment treaties under the auspices of which contracts are signed and renegotiated, relying exclusively on domestic law for the effective governance of these contracts is a policy bound to fail. On the contrary, international law has an indispensable role to play in the sustainable governance of concessions and, consequently, the more balanced adjudication of disputes between host states and foreign investors.

The focus in this context is on the role of arbitration as a governance mechanism for the "fair and equitable" resolution of disputes ensuing from the renegotiation of concession contracts and the design of interpretative, evidentiary, and procedural tools to achieve this end. Given the powerful role of arbitration in imposing both monetary and reputational costs on the disputing parties, the adoption by tribunals of such adaptive-governance tools would also achieve, in a backward induction, the better alignment of the parties' incentives in implementing their contract and the ensuing alleviation of the transaction costs of bounded rationality and opportunism.

Being “hybrid”, complex PPP contracts, concession contracts constitute a *sui generis* subcategory of state contracts.[62] On the one hand, they are “public”, regulatory contracts that include rules for the provision of a public service by a private monopolist. On the other hand, they also operate as “private”, commercial contracts, lying on the premise of the economic equilibrium of the PPP relationship, and the “reasonable profit” of the investor.

Nevertheless, international arbitrators have so far addressed this dual nature of PPP contracts in a rather one-sided, rigid way, following primarily the tenets of classical contract law (or its public-international-law counterpart, the textualist methodology of the

[62] Frick, J. (2001), *Arbitration and Complex International Contracts*, Kluwer Law International.

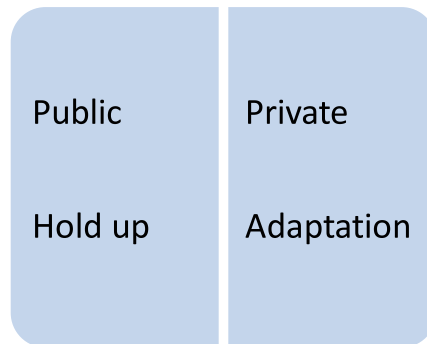
Vienna Convention on the Law of Treaties). The focus so far has been mostly on the protection of foreign investors from changes of the regulatory terms of the contract adversely affecting their legitimate expectations. Less consideration has been given, though, to the need for the renegotiation and adaptation of such complex, long-term commercial contracts – a need that can validly be invoked by both parties, as illustrated *inter alia* by the UNIDROIT Principles of International Commercial Contracts.[63]

It ensues from the above that a more holistic perspective of the hybrid nature of concession contracts is needed, meaning a perspective that would link their public and private sides with both of the parties, the state and the investor. In other words, the delegation of a public (usually monopolistic) function to a private investor renders the public-private dichotomy invalid. In this context, the public partner may behave like a private party to a commercial contract, asking for the adaptation of the latter to changed circumstances, in a similar way that the private partner may behave as a public party, having the authority to hold-up the government and extract rents from this bilateral-monopoly relationship at the expense of consumers and taxpayers.

Consequently, a mutual perspective on adaptive governance from the part of arbitrators would better reflect the need of both parties to adjust their initial commercial deal, as needs develop or hardship occurs, while accounting not only for the risk of governmental opportunism (for example, by means of expropriation), but also for a potential hold-up and opportunistic behavior from the part of the private monopolist.

By means of a simple graph, this public-private interchange of roles can be depicted as follows:

[63] See the Separate Opinion of arbitrator *Pedro Nikken* in the *Suez v. Argentina* case, at 48: "I do not agree with the assumption expressed in the Decision (para. 239) that AASA was coerced into acceding to the renegotiation because, had it refused, it could have been accused of violating Article 5.1 of the Concession Agreement, which obligated both sides to *use all means available to establish and maintain a fluid relationship which would facilitate the discharge of this Concession Agreement*. Rather, I believe that this clause is evidence that the obligation to renegotiate did not have as its sole source the Emergency Law, but the Concession Contract itself and that AASA could not lawfully refuse to renegotiate (as in fact it did not refuse). Moreover, the international standard for such contracts in the event of *hardship* aims to impose an obligation on the parties to negotiate an adaptation of the contract to the changed circumstances or the termination of the contract which is moreover, in my opinion, a corollary of the good faith that should prevail in the execution of any contract."



As explained further below, the renegotiation and adaptation of concession contracts shall be based on the tenets of relational contract theory. The relational nature of concession contracts means that the foreign investor has to accept renegotiations initiated by the host state, under certain circumstances making contractual adaptations indispensable. This relational-contract perspective has significant implications for the adjudication of treaty disputes, as, in principle, a foreign investor shall not be entitled to claim a treaty breach - namely the breach of FET - as a result of a contractual renegotiation requested by the host state in the face of a material change of circumstances calling for the adaptation of the contract to the new situation. The question thus arising in this context is under which conditions a contractual renegotiation is legal and legitimate under international investment law.

This is the question that the following chapters aim to address by examining the connection between the concession contract and the overarching treaty. To this end, the second chapter develops further the argument on the internationalization[64] of contracts, by showing that the contract-treaty relationship works both ways, and is dynamic and mutual. This means that not only treaties have an impact on the underlying contracts, but also contracts have a direct bearing on the adjudication of the treaty, when the issue of a contractual renegotiation is at stake.

The focus herein is on the FET standard as the provision exemplifying most clearly such connection, especially through the doctrine of the investor's "legitimate expectations"

[64] See Voss, J.O., *supra* note 45.

emanating from the concession contract and its regulatory framework. The thesis similarly argues that the strict distinction between "contract claims" and "treaty claims" is largely artificial, and adopts, instead, an integrationist approach - to quote *Crawford* (2008)[65] - according to which the two instruments cannot be treated in isolation from each other.

Building on the findings of the second chapter demonstrating the inextricable link between the concession contracts and the overarching treaties, the third chapter demonstrates that international investment treaties are incomplete contracts themselves, containing vague standards that operate as default rules, completed by the underlying contracts.[66] To this end, the chapter analyzes the perspective of "treaties as contracts", and more specifically of international investment treaties as relational contracts.

The particular emphasis is, as aforementioned, on the inherently vague, dynamic, and context-specific treaty standard of "fair and equitable treatment". The theoretical analysis succeeds the empirical analysis of arbitral case law addressing the relationship between contractual renegotiations and the breach of FET. The ensuing awards have often led to contradictory results, ranging from a rigid, textualist interpretative methodology akin to classical contract theory, to more balanced approaches attempting to accommodate the needs of both parties and the inevitable renegotiation of the contract based on the principles of relational contract theory.

The purpose of the examination of the relevant case law is, thus, dual: first, evidence how arbitrators have judged an alleged breach of FET as a result of a contractual renegotiation, and second (and more importantly from a policy perspective), address the question "whether and when a contractual renegotiation violates the treaty standard of fair and equitable treatment", thus laying the foundations for the development of criteria under which a contractual renegotiation is legal and legitimate under international law, and achieving a better balance between the conflicting public and private interests involved.

In order for arbitral tribunals to achieve a balanced (or truly "fair and equitable") interpretation of FET, renegotiations have to be evaluated and interpreted through the lenses of "law in action", and not simply "law on paper". This means that tribunals have

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[65] Crawford, J. (2008), *Treaty and Contract in Investment Arbitration*, Arbitration International, 24 (3): 351.

[66] On the nature of international investment treaties as incomplete contracts, see van Aaken, A. (2014), *Control Mechanisms in International Investment Law*, in: Douglas, Z., Pauwelyn, J. & Viñuales, J. (Eds), *The Foundations of International Investment Law, Bringing Theory into Practice*, Oxford University Press. Similarly, on the trade-off between commitment and flexibility in international investment law, see van Aaken, A. (2009), *International Investment Law between Commitment and Flexibility: A Contract Theory Analysis*, Journal of International Economic Law, 12 (2): 507.

to look at both sides of the scale when judging whether a contractual renegotiation breached FET, and particularly the investor's "legitimate expectations". In an environment where renegotiations - as attested in the economics findings analyzed below - are a standard practice of the parties, often initiated also by investors, the tribunal needs all the necessary evidence to evaluate what the "legitimate expectations" of the parties actually are.

For example, if on the basis of such holistic evidence, the investor is found to have initiated renegotiations of the concession contract (leading to more favorable investment terms compared to those offered during the bidding process), then the investor shall be *estopped* from claiming a breach of its treaty rights as a sole result of a subsequent renegotiation requested by the state. In any case, the investor's conduct throughout the entire implementation of the contract must also be taken into account (along with the conduct of the state) in determining what its "legitimate expectations" have been.

In other words, as analyzed in the third chapter, the interpretation of investment treaties (namely of FET) has to be based on the relational tenets of "dynamism" and "mutuality". FET is an evolutionary standard, much like the standards included in relational contracts, and as a result, the "legitimate expectations" of the parties have to be determined in a mutual and dynamic way (as opposed to the static and one-sided tenets of classical contract theory, which most investment tribunals have followed so far).

Last, in order to operationalize the theoretical and empirical findings of the preceding chapters, the last chapter proposes certain de *lege ferenda* recommendations, addressing *inter alia* the issue of evidence. In particular, the proposed design of penalty default rules would assign the burden for the production of evidence to the party that initiated a renegotiation and require that it presents the tribunal with the reasons for such renegotiation, its outcome and the plan submitted to fulfill the new contractual obligations. To this end, tribunals shall request (and the parties shall provide) all the material evidence on each renegotiation that has taken place since the signing of the contract.

Such evidence is indispensable to determine what the "legitimate expectations" of the parties have been and the alleged causation between the renegotiation and the damages that the investor suffered.[67] In this context, if an investor - as the findings from Economics demonstrate - had also initiated renegotiations of the concession contract prior to the one that led to the treaty dispute, a claim that the last renegotiation violated

[67] On the particular issues arising in the context of complex long-term contracts and the award of damages, see Wöss, H., San Román Rivera, A., Spiller, P. & Dellepiane, S. (2014), *Damages in International Arbitration under Complex Long-Term Contracts*, Oxford University Press.

any "legitimate expectations" based on the "stability of the business and legal framework of the concession" would be blocked by the doctrine of *estoppel*.

Moreover, in the event of such investor-led renegotiations (which can be expected in complex, long-term, relational contracts), the threshold for finding a violation of FET due to a subsequent, state-led renegotiation shall be high (instead of the reverse case, i.e. a high threshold for the defense of necessity) and the tribunals have to develop clear criteria meeting such threshold. In summary, the proper allocation of the burden of proof between the parties[68] would force a better alignment of their incentives, thus reducing the incidence of opportunistic renegotiations.

Moreover, producing evidence on all renegotiation processes is important to address the hazard of corrupt renegotiations. As attested empirically, corrupt renegotiations are anything but uncommon in concession contracts.[69] If the investor-state dispute settlement system is to contribute to limiting opportunistic and corrupt renegotiations, tribunals shall take into account corruption already in determining the admissibility of a claim brought before them.

Corruption was condemned already in Judge *Lagergren's* seminal arbitral award of 1963 as "a gross violation of public morals and international public policy"[70] leading him to deny jurisdiction on the basis that the parties "had forfeited any right to ask for assistance of the machinery of justice in settling their disputes." However, the problem has been widely disregarded ever since, despite its huge implications for the (political) sustainability of an investment, as well as for social welfare. The very high standard of proof for corruption has made it considerably difficult to produce convincing evidence.[71]

[68] The production of evidence and the burdens of proof are even more sensitive issues in the case of incomplete contracts with their ensuing challenges for the verifiability of contingencies, as mentioned above. In this context, the proper allocation of the burdens of proof can be a useful transaction-cost economizing device. On the connection of evidentiary burdens with the cost-effectiveness of litigation when incomplete contracts are involved, see Scott, R. & Triantis, G. (2006), *Anticipating Litigation in Contract Design*, The Yale Law Journal, 115 (4): 814.

[69] See, *inter alia*, Guasch, J.L. & Straub, S. (2009), *Corruption and Concession Renegotiations. Evidence from the water and transport sectors in Latin America,* Utilities Policy, 17 (2): 185.

[70] Even an "international evil." See ICC Award No. 1110 of 1963 by Gunnar Lagergren, YCA 1996, at 47 et seq.

[71] See Wells, L. (2010), *Backlash to Investment Arbitration: Three Causes*, in: Waibel, M., Kaushal, A., Chung, K.H. & Balchin, C. (Eds), *The Backlash against Investment Arbitration: Perceptions and Reality*, at 347. *Siemens AG v. Argentina* was among the cases where there was lack of evidence for corruption during the proceedings, yet the company was subsequently found guilty of bribery under the Foreign Corrupt Practices Act leading Argentina to seek revision of the ruling and Siemens to waive its rights under the arbitral award against the state. See Peterson, L. E. (2009), *Siemens Waives Rights under Arbitral Award against Argentina; Company's Belated Corruption Confessions Had Led Argentina to Seek Revision of 2007 Ruling*, Retrieved from: https://www.iareporter.com/articles/siemens-waives-rights-under-arbitral-award-against-argentina-follows-companys-belated-corruption-confessions/

The trend has started changing with the recent ICSID awards in *World Duty Free Company Limited v. the Republic of Kenya*[72] and *Metal-Tech v. Uzbekistan*.[73]

Another concrete normative proposal for enhancing the adaptive governance of the contractual relationship and the connection between the contract and the treaty is the more widespread use of the UNIDROIT Principles of International Commercial Contracts for resolving treaty disputes ensuing from the renegotiation of the underlying investment contracts (the Principles have already been invoked as relevant tools for the interpretation of investment treaties, in the *El Paso* and *Suez* cases).

The second chapter examines the UNIDROIT Principles on hardship, its status under international law, and its potential to be used as a general principle of law in the adjudication of treaty disputes. The application of the UNIDROIT hardship defense can bring a novel perspective in the balanced resolution of investor-state disputes, as it is a legal standard less rigid than the necessity defense under public international law, thus placing the disputing parties on a more equal footing regarding their ability to request the adaptation of their contract to changed circumstances.

Unlike previous research that has focused on public-law tools to balance public and private interests,[74] like the principle of proportionality drawn from the realm of administrative law, or interpretative notes clarifying the meaning of certain treaty standards,[75] this thesis argues that private-law tools, available to both parties, are equally important for achieving such balance.[76] In the particular context of the renegotiation of

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[72] *World Duty Free Company Limited v. Kenya*, ICSID Case No. ARB/00/7, Award, 4 October 2006.
[73] *Metal-Tech Ltd. v. Republic of Uzbekistan*, ICSID Case No. ARB/10/3, Award, 4 October 2013.
[74] See *inter alia* Van Harten, G. (2009), *Investment Treaty Arbitration and Public Law*, Oxford Scholarship Online, as well as Van Harten, G. & Loughlin, M. (2006), *Investment Treaty Arbitration as a Species of Global Administrative Law,* The European Journal of International Law, 17 (1): 121, and also Schill, S. (2011), *International Investment Law and Comparative Public Law*, Oxford Scholarship Online.
[75] For example, the interpretative note regarding certain chapter 11 provisions of the NAFTA, adopted by the Free Trade Commission. The interpretation mechanism for adapting a treaty to changed circumstances or correcting an interpretation advanced by arbitrators could be seen with some skepticism in view of the fact that international investment treaties themselves are also inherently incomplete contracts that cannot provide for all contingencies, thus leaving significant discretion to arbitrators to decide on their standards.
[76] It is important to differentiate among types of investment disputes and the different stakes involved. As explained already in the beginning of the chapter, this thesis focuses on the particular type of disputes ensuing from infrastructure PPPs whereby the operation and control of strategic public services is delegated to a private, foreign investor. On the differentiation of investment disputes see Maupin, J. (2014), *Differentiating Among International Investment Disputes*, in: Douglas, Z., Pauwelyn, J. & Viñuales, J. (Eds), The Foundations of International Investment Law, Bringing Theory into Practice, Oxford University Press, at 467-498.

PPP contracts, arbitrators need to develop not only public[77] but also private[78] legal tools that will facilitate the adaptive governance of the parties' relationship.

The last normative proposal that the final chapter makes is the use of international mediation as a governance mechanism for facilitating the adaptability of the contract. The proposed mediation design places the emphasis on the renegotiation process *per se*, and its implementation in a good-faith, depoliticized, transparent and balanced manner. Along with interpretative rules and mechanisms for addressing renegotiation as a central legal matter in international arbitration, the process of the renegotiation itself shall be given more visibility and transparency. The very nature of mediation as an independent mechanism aiming at the early resolution of investor-state conflicts, and the cooperative adaptation of the parties' long-term relationship, makes it appropriate for the neutral, de-politicized and non-opportunistic management of the renegotiation process.[79]

b) *Novelty of the Argument*

To summarize, the novel perspective adopted in this thesis is its realistic view of the actual bargaining power and behavior of both the host state and the foreign investor. By taking into account the truly "hybrid" nature of the investment-law regime,[80] especially in the case of PPP contracts, it argues that both the state can act as a "private" party, requesting the legitimate adaptation of a complex, long-term contract, and the investor

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[77] Like the - rather limited in its application, as indicated by the ICJ in the Fisheries Jurisdiction case ([1974] ICJ Rep 3) - clause of "rebus sic stantibus", incorporated in article 62 of the Vienna Convention on the Law of the Treaties, as a counterbalance to the principle of "pacta sunt servanda" included in article 26 of the same Convention. The importance of "rebus sic stantibus" was also demonstrated by the recent global economic crisis. See Ferré, H. & Duggal, K. (2011), *The world economic crisis as a changed circumstance*, Retrieved from : http://ccsi.columbia.edu/files/2014/01/FDI_43.pdf

[78] Particularly the UNIDROIT principles of international commercial contracts. On the emerging importance of the principles in addressing the problems arising in the particular context of long-term investment contracts (as PPP contracts are *par excellence*), see the ongoing study of the International Institute for the Unification of Private Law at: http://www.unidroit.org/work-in-progress-studies/current-studies/long-term-contracts. See also Bonell, M.J. (2014), *The UNIDROIT Principles of International Commercial Contracts and Long-Term Contracts*, Retrieved from: http://www.unidroit.org/english/documents/2014/study50/s-50-126-e.pdf. On the potential deployment of the UNIDROIT principles in international investment arbitration, see Bonell, M.J. (2013), *Model Clauses for Use of the UNIDROIT Principles of International Commercial Contracts in Transnational Contract and Dispute Resolution Practice*, Retrieved from: http://www.unidroit.org/english/documents/2013/study50/mc/s-50-mc-01rev-e.pdf

[79] von Kumberg, W.J., Lack, J., & Leathes, M. (2014), *Enabling Early Settlement in Investor-State Arbitration - The Time to Introduce Mediation Has Come*, ICSID Review, 28 (3): 133.

[80] On the origins of international investment arbitration in commercial arbitration and the subsequent extension of the arbitral regime to settling regulatory disputes see Van Harten, G. (2009), *supra* note 74. On the hybrid nature of international investment arbitration, see Douglas, Z. (2003), *The Hybrid Foundations of Investment Treaty Arbitration,* British Yearbook of International Law, 74 (1): 151.

has the power, as a private monopolist, to act as a "public" actor, potentially holding up the government and initiating strategic renegotiations in a non-competitive environment. In such a complex landscape, international investment arbitration is called upon to address both eventualities and hazards, thus renouncing a rigid public-private dichotomy.[81] The development by arbitrators of the underexplored international rules and mechanisms, and especially the interpretative principles facilitating the sustainable adaptation of the PPP contract, is the gap that the present research aims to fill.

This gap can be filled by developing the criteria that arbitral tribunals shall use to determine whether the renegotiation of a concession contract constitutes a breach of treaty, namely the "fair and equitable treatment" standard. Such adjudication should be based on an approach bridging law and (transaction cost) economics, or "law on paper" and "law in action". This means that, in order to evaluate whether a contractual renegotiation has violated the FET standard, arbitrators have to take into account the governance of the contract and the progress of any renegotiations in their entirety.

In a nutshell, the purpose herein is to assist arbitrators in developing criteria differentiating a law-abiding renegotiation from one that violates the treaty. Given the inherent vagueness and mutability of the FET standard, arbitrators have to turn to the tenets of relational contract theory as the appropriate interpretative method for determining the content of "fair and equitable treatment."

A relational interpretation of FET, based on the proxies of "mutuality" and "dynamism" would even out some of the asymmetries resulting from the inequality of arms given to foreign investors and host states under international law. Whereas contracts are often renegotiated when foreign investors face hardship or even less severe financial difficulties, the state does not have an equal option to resort to arbitration to collect damages from a noncompliant investor. Thus yielding to a request for renegotiation[82] might often be its only option, if the investor insists on not following the earlier deal.

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[81] On a legal-realist approach to the role of adjudicators see Posner, R. (2011), *Realism about Judges*, Northwestern University Law Review, 105 (2): 577, at 577: "The courts must address themselves in some instances to issues of social policy, not because this is particularly desirable, but because often there is no feasible alternative. […] The realistic theory can be traced back to Plato's dialogues, before t there was a legal profession or professional judges. In the *Apology*, Socrates notes that each judge […] has sworn that he will judge according to the laws, and not according to his own good pleasure"- but in *Gorgias* Socrates predicts that his trial will be the equivalent of the trial of a doctor prosecuted by a cook before a jury of children. And in the *Republic* Thrasymachus argues that justice is simply the will of the stronger". See also Llewellyn, K. (1931), *Some Realism about Realism: Responding to Dean Pound*, Harvard Law Review, 44 (8): 1222.

[82] For such a strong (according to the *amici curiae*, opportunistic) investor-led request for renegotiation of the initial contract see, for example, the case of *Biwater Gauff (Tanzania) LTD v. United Republic of Tanzania*, ICSID No. ARB/05/22, July 24, 2008.

This imbalance in international investment arbitration was exemplified by the case of *Aguas Argentinas*.[83] *Suez et al* had initiated renegotiations to achieve contractual terms more favorable to them (including the indexation of the water tariffs to the dollar - a provision that was not part of the original contract, yet became a core issue of the subsequent arbitral award against Argentina). The government had no international rights to enforce the terms of the original contract, when faced with the investor's demands. On the other hand, when Argentina came under pressure to renegotiate due to the economic depression that hit the country in the late 1990s, the lead investor sued the state under the BIT between France and Argentina requesting the enforcement of the most recent version of its contract.[84]

The perspective of this thesis is not only novel but also timely. Despite the time that has elapsed from the wave of investment contracts in energy infrastructure that marked the era of the "Washington Consensus", the relevant cases remain as timely as ever. First, several of these renegotiation cases, especially those that arose from the Argentine crisis, are still under consideration, or their adjudication was concluded only recently (giving rise to lengthy - and sometimes also novel awards, such as in *Urbaser*,[85] where the tribunal took a more relational-contract-theory approach by looking also at the investors' conduct and holding them accountable for human-rights violations).

Second, the issue of contractual renegotiations and modifications, and the ensuing alleged breach of the overarching treaty keeps arising in numerous cases. An example is the recent ruling on the termination of the Egyptian contracts for the development of the Egypt-Israel gas pipeline, where the ICSID tribunal looked into the ICC award on the allegedly disproportionate contract termination to decide whether there was a breach of the bilateral investment treaty in dispute.[86] Third, the privatization of energy infrastructure remains in general a very timely practice, as demonstrates *inter alia* the ICSID claim that the Spanish energy company *Gas Natural Fenosa* has threatened to file against Colombia to recover electricity payments owed by customers near the country's Caribbean coast.[87]

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[83] See the *Suez v. Argentina* award, *supra* note 61.

[84] See Wells, L., *supra* note 75, *Backlash to Investment Arbitration: Three Causes*, in: Waibel, M., Kaushal, A., Chung, K.H. & Balchin, C. (Eds), *The Backlash against Investment Arbitration: Perceptions and Reality*, Kluwer Law International, at 345-346.

[85] *Urbaser S.A. and Consorcio de Aguas Bilbao Bizkaia, Bilbao Bizkaia Ur Partzuergoa v. The Argentine Republic*, ICSID Case No. ARB/07/26, Award, 8 December 2016.

[86] https://www.iareporter.com/articles/in-new-egypt-ruling-disproportionate-contract-termination-and-failure-to-prevent-pipeline-attacks-underpin-fortier-chaired-tribunals-findings-of-bit-breach/

[87] http://globalarbitrationreview.com/article/1138238/colombia-will-face-billion-euro-power-claim

c) Analytical Framework

The analytical lenses through which the problem of contractual renegotiations is addressed are those of transaction cost economics, and particularly the theory of incomplete contracts. Transaction cost economics (herein, TCE) is the appropriate analytical framework to address the governance of contractual relations. The purpose of TCE is to economize on the transaction costs of bounded rationality and opportunism. These hazards are even more acute in the case of incomplete contracts with their ensuing difficulties for the verifiability of contingencies and the enforcement of the relevant provisions.

According to *Commons* (1932), "the ultimate unit of activity must contain in itself the three principles of conflict, mutuality, and order. This unit is a transaction." [88] TCE focuses on transactions as the main units of analysis and posits that "governance" is the means by which order can be achieved by overcoming conflicts between the contractual parties with a view to achieving mutual gains. Unlike simple market transactions that are executed instantly, "governance" is the management of ongoing contractual relations, and as such, it is essential for the implementation of complex, long-term contracts.[89]

Infrastructure concession contracts belong to the category of inherently incomplete contracts.[90] They are developed in conditions of bilateral-dependency where two key behavioral assumptions hold: on the one hand, bounded rationality makes it impossible for the parties to predict in advance every single contingency that may arise during the whole life cycle of the project. This reality makes the renegotiation and adaptation of the contractual relationship an inevitable fact. On the other hand, asset specificity and the (political) costs for admitting failure of a privatization program and changing the incumbent locks the two PPP parties in a relationship of potential hold-up and opportunistic behavior.

In this context of bilateral dependency, the purpose of TCE is to examine those governance structures that can facilitate the good-faith renegotiation and adaptation of the concession contract by preventing the risks to its long-term success resulting from bounded rationality and opportunism. More specifically, the focus of this thesis is on the institutions that can achieve this long-term governance of the concession contract.

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[88] Commons, J. (1932), *The Problem of Correlating Law, Economics, and Ethics*, Wisconsin Law Review 8(1): 3.

[89] Williamson, O. (1998), *The Institutions of Governance*, The American Economic Review, 88 (2): 75.

[90] On the three-way classification of contracts into classical, neoclassical, and relational contracts (an issue that will be analyzed in the following chapter), see Macneil, I. (1978), *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law,* Northwestern University Law Review, 72 (6): 854.

Building on the above general tenets of TCE, there are two core arguments forming the backbone of the analytical framework deployed herein. On the one hand, the international investment contract is a governance tool susceptible to adaptation to changing circumstances and needs.[91] On the other hand, the institution examined as a governance structure is international investment arbitration. Arbitration is a form of global administrative governance having the potential to create incentives for the sustainable renegotiation and adaptation of the underlying contracts by economizing on the transaction costs of bounded rationality and opportunism.

Last, another reason why TCE fits the analytical purposes of this thesis is its intellectual rigor and interdisciplinary method. The problem-solving approach adopted herein requires an active and interdisciplinary mindset prepared to cross disciplinary boundaries in order to address the question "what is going on here"? Why is renegotiation a legal issue largely unaddressed in international investment arbitration, despite its pervasiveness in practice, according to findings in the economics research? What are the rules and mechanisms to fill this gap and contribute to the sustainable adaptation of PPP contracts, drawing from insights from the domains of law, economics, and behavioral psychology?[92]

The application of the analytical framework of TCE in the field of international investment arbitration is a novel approach, promising to yield new insights in addressing the imbalances between the PPP parties produced by the adjudication of high-profile cases in the strategic domain of infrastructure industries. Using the tools of TCE and economic contract theory to address the way that arbitrators have adjudicated the renegotiation of international investment contracts can offer a better understanding of the trade-off between commitment and flexibility in international investment law[93] and its implications for the sustainability of infrastructure PPPs.

In this context, the relationship between relational contract theory and transaction cost economics is one of means to an end. In other words, the application of relational contract theory as the proper interpretative method for determining the content of FET is the means to achieve the purposes of economizing on the transaction costs of bounded rationality and opportunism both during the adjudication of treaty disputes ensuing from contractual renegotiations and, through a backward induction, during the governance of the underlying concession contracts.

[91] See *supra* Williamson, O. (1981), at 550.

[92] Williamson, O. (2010), Transaction Cost Economics: The Natural Progression, The American Economic Review, 100 (3): 673, at 682.

[93] See van Aaken, A. (2009), *supra* note 66.

d) Methodology

The methodology deployed herein is based on the review and analysis of arbitral jurisprudence addressing the issue of the renegotiation of infrastructure concession contracts. The use of the *Langdellian*, case method is the appropriate methodology to address a legal problem arising in the relatively nascent field of modern investment arbitration. Applying this inductive approach would help gain practical insights into the actual state of affairs in international arbitration, and more specifically how arbitrators have addressed the trade-off between commitment and flexibility, and what the final outcome of the relevant cases (including the politics of the (non-) enforcement of the resulting awards) has been.

One of the principal aims of the inductive, case method is to examine whether there has been consistency in the way arbitrators have judged renegotiation, and if any common patterns have emerged from their legal reasoning. In a preliminary note, such consistent patterns have not developed so far. For example, in *Aguas Argentinas* the renegotiations that took place during the implementation of the contract were viewed as secondary facts subject only to a passing note indicating the cooperative relationship of the parties until the country's economy and the concession collapsed.[94] Notably, though, there was no consensus among the members of the tribunal regarding the legal effects of the disputed renegotiation. Arbitrator *Nikken* dissented both with regard to the role of "legitimate expectations" for evaluating FET, and by stressing the inevitability of renegotiation in case of hardship, which he considered the applicable "international legal standard" for the adaptation of investment contracts, and a corollary of the general principle of "good faith".[95]

Contrary to *Aguas Argentinas*, renegotiation was in the spotlight of the decision in *Biwater v. Tanzania*,[96] in terms of both substance and process. The renegotiation initiated by *Biwater* was placed under extensive evidentiary scrutiny before the investment tribunal, particularly with regard to the actual motives for the renegotiation, the investor's performance during the life of the contract and the connection of the renegotiation with the alleged causation of harm to the company by the Republic of Tanzania. In procedural terms, renegotiation was assigned to independent mediators, thus avoiding the high

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[94] *See* the *Suez* award *supra* note 61, at 17, para. 40: "The significance of these revisions and renegotiations lies not in the details of what the parties discussed and agreed but rather in what they suggest about the parties' relationship with and intentions toward each other. […] Argentina has suggested another interpretation for the revisions and renegotiations: that the claimants made an unrealistically low bid in order to win the Concession and thereafter used the revision and renegotiation processes to secure tariff increases, which if they had been included in the original bid, would not have gained the claimants the Concession in the first place. Other than supposition, Argentina offered no evidence to support this interpretation of the Claimant's actions."

[95] See *supra* note 63, paras 45-50.

[96] On the *Biwater* case, see *supra* note 82.

politicization of the process and the lack of transparency that characterized the renegotiations in the case of *Aguas Argentinas*, which took place directly between the government and the investor upon bypassing the regulator.

While arbitral cases are examined throughout the thesis, the third chapter focuses in particular on the treaty disputes that arose from the renegotiation of concession contracts following the Argentine economic crisis. The analysis complements a matrix (presented in Annex) showing the divergent approaches that arbitral tribunals have taken to renegotiation, ranging from a rigid, textualist interpretative approach akin to classical contract theory to a more dynamic and mutual interpretation coming closer to the tenets of relational contract theory, and recognizing the need for the good-faith adaptation and renegotiation of the underlying concession contracts.

CHAPTER I: Concession Contracts as Relational Contracts

1. Why the nature of concession contracts matters?

This section expands on the characteristics of relational contracts and the tenets of relational contract theory that are applicable to concession contracts. As explained in the following two parts, the nature of concession contracts is relevant for the interpretative method that arbitrators are expected to apply while interpreting the standards of investment treaties. In other words, the relational character of such underlying contracts calls for the use of relational contract theory as the most appropriate method to interpret the dynamic standards of investment treaties when adjudicating disputes involving these contracts.

The rationale of matching investment-treaty disputes with the underlying contracts is backed in theory by scholars supporting the differentiation of such disputes on the basis of their underlying characteristics. *Maupin* argues that investor-state disputes vary widely in terms of socio-legal, territorial, and political impacts, and that such important variances require a differentiated approach to investor-state dispute settlement. That is to say that different classes of investment claims shall be matched with different types of dispute resolution mechanisms that correspond better to the claims' underlying characteristics.[97]

Recognizing the heterogeneity of investment disputes, *Maupin* constructs a matrix organizing the differing attributes of investment disputes along three dimensions. These are the "socio-legal continuum (individual to societal)", the "territorial continuum (local to transnational)," and the "political continuum (commonplace to contested)." Disputes arising from concession contracts are placed at the high end of the socio-legal and political continua, as concessions operate in highly sensitive and strategic sectors with wide impact on the general population of the host state. *Maupin* makes specific reference to the *Suez* case[98] as a complex dispute involving both treaty-based complications and the specific investor-state contractual relationship, as well as profound negative externalities produced by both instruments for the consumers of the host state.[99]

[97] See Maupin, J., *supra* note 76. Maupin's logic echoes the rationale of transaction cost economics, and more specifically Williamson's argument for matching the transactions' characteristics (herein, disputes' characteristics) with the appropriate governance structures (herein, dispute resolution mechanisms).
[98] See the *Suez* award, *supra* note 61.
[99] See Maupin, J., *supra* note 76, at 5-6.

Following the logic of the "differentiation methodology" using the disputes' underlying characteristics, this section aims at differentiating such disputes on the basis of the characteristics of the underlying instruments, namely the contractual relationships between the investor and the host state. As described below, there are different categories of contracts, which present distinct challenges for their governance as well as the disputes arising from their implementation. The argument made herein is that concession contracts are contracts bearing strong relational characteristics, and consequently their renegotiation, and especially the resolution of disputes resulting from such renegotiation, shall be conducted using a "relational methodology."

2. The three-way classification of contracts

a) Classification of contracts and legal realism

The distinction of contracts into classical, neoclassical, and relational has its antecedents in Legal Realism and the school of New Institutional Economics. For this reason, prior to examining specifically the three-way classification of contracts as introduced by *Macneil*[100] and refined by *Williamson*,[101] it is useful to link the relevant literature to its origins, namely the work of *Karl Llewellyn*[102] on the implications of legal realism for contract law, and ultimately for the development of the concept of relational contracting.

To begin with, there is not one single school of legal realism or uniform methodological tools; nevertheless there are some common points of departure for legal realists,[103] which the present thesis endorses and adopts as part of its analytical framework. Among the tenets of legal realists is the conception of the law as being in a state of flux, as well as the object of judicial creation.

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[100] Macneil, I. (1974), *The Many Futures of Contract*s, Southern California Law Review, 47:691 and Macneil, I. (1974), *Restatement (Second) of Contracts and Presentiation*, Virginia Law Review, 60 (4): 589. See also Macneil, I. (1978), *supra* note Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law, Northwestern University Law Review, 72 (6): 854 and Macneil, I. (1980), *The New Social Contract: An Inquiry into Modern Contractual Relations*, Yale University Press, as well as Macneil, I. (1985), *Relational Contract: What we do and do not know*, Wisconsin Law Review, 483.

[101] Williamson, O., *Transaction-Cost Economics: The Governance of Contractual Relations*, Journal of Law and Economics, 22 (2): 233.

[102] Llewellyn, K. (2008), *Jurisprudence, Realism in Theory and Practice*, Routledge, and Llewellyn, K. (1931), *supra* note What Price Contract? An Essay in Perspective, The Yale Law Journal, 40 (5): 704.

[103] Llwellyn, K. (1931), *supra* note Some Realism about Realism: Responding to Dean Pound, Harvard Law Review, 44 (8): 1222, at 1235-1238.

Being creative while interpreting the law, judges are often driven by considerations of "equity".[104] The importance of equity is also evident in investment arbitration, wherein arbitrators are often called to judge the vague (and most widely invoked) standard of fair and equitable treatment.[105] Similarly, the law is not an end in itself but only a means to serving the ends of the society, which is itself also in flux. Thus the law is expected to adjust accordingly to the changing social needs, in order for inconsistencies between the law on paper and the law in action to be avoided.[106]

Another important principle of the legal realist movement, and a valuable methodological tool for the purposes of the present thesis, is the temporary distinction between "de lege lata" and "de lege ferenda", meaning the "is" and the "ought" of legal responses to social problems. Whereas value judgments drive the goals of the inquiry the observation and the establishment of relations between the examined objects are uncontaminated (as much as possible) by the (ethical) wishes of the researcher.

Obviously the separation of deontology from ontology is only temporary and ultimately serves the motivation of the realist scholar to propose the change that she suspects the law needs. In order, though, for such change to take place, an informed and objective investigation of the facts is first necessary in order to establish the actual state of the law. In the case of courts (or arbitral tribunals) this objective evaluation means that, in the beginning of the analysis, the realist aims to determine what the courts are in fact doing, prior to recommending what they ought to do.

Translating the realist approach into the subject of the present research, this thesis operates on two levels: On a first level, it takes into account the empirical data of economics attesting to the actual contractual practice of the parties to a concession contract. Subsequently, it reviews the relevant case law of investment tribunals, as it has actually evolved to this date. After having performed an objective examination and evaluation of these empirical issues, it aims, on a second level, to draw several deontological conclusions about the way courts should judge the cases involving concession contracts.

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[104] The importance of equity in the interpretative practices of judges was recognized in 1910, in the seminal article of Roscoe Pound on legal realism. See Pound, R. (1910), *Law in Books and Law in Action*, American Law Review, 44: 12, at 19-23.

[105] On fair and equitable treatment as a mechanism of global governance, see Kingsbury, B. & Schill, S. (2009), *Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law*, NYU School of Law, Public Law Research Paper No. 09-46, Retrieved from: SSRN: https://ssrn.com/abstract=1466980 or http://dx.doi.org/10.2139/ssrn.1466980

[106] On the divergence between the law on the books and the law in action, see Pound (1910), *supra* at 20, where he emphasizes the role of judges in going beyond "the four corners" of the textbook law while engaged in the creation of the law in practice.

The essence of legal realism, which the present thesis fully subscribes to, is the adoption of a bottom-up reasoning that springs from the ground, that is, the "law in action". This bottom-up approach starts exploring and explaining the meaning of the law by observing what is actually happening on the ground, during the law's implementation. These observations arise both from the implementation of the contract by the parties and the findings of the courts in the event of a dispute. The legal-realist reasoning espoused herein aims to deduct from these observations prescriptive conclusions on the way that the law should be improved, especially through the adoption of proper interpretative techniques aligning the "law in books" with the "law in action".[107]

More specifically, the analytical framework deployed herein, i.e. that of transaction cost economics with particular emphasis on the theory of relational contracting, belongs to the movement of legal realism.[108] Relational contract theory is realistic in the sense that it views the contract as the mere framework within which the relationship of the parties is developed on the ground, as opposed to a set of rigid legal rules.

To cite *Llewellyn*, "the major importance of the contract is to provide a *framework* for well-nigh every type of group organization and well-nigh every type of passing or permanent relation between individuals and groups, up to and including *states*[109] - a *framework highly adjustable*, a framework which almost never accurately indicates *real* working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt [...] The direct legal sanctions are not the major measure of importance." [110] This realistic legal approach to contracting is corroborated by the empirical evidence of the frequent renegotiations of concession contracts, which shows precisely the relational character of the latter and the adaptation of the law to the real needs of the parties, as they evolve.

Prior to analyzing the distinctive features of relational contracts, it is apposite to refer to *Macneil's* categorization of contracts into classical, neoclassical, and last, relational. This categorization revolves around the three axes characterizing transactions, according to the analytical framework of transaction cost economics. As a reminder, the three critical

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[107] On the pioneering legal movement in contract law (the so-called "the Wisconsin Supplement") aiming at developing "law in action", see Macaulay, S., Braucher, J., Kidwell, J. & Whitford, W. (2010), *Contracts: Law in Action,* Michie Co. See also Macaulay, S. & Whitford, W. (2015), *The Development of Contracts: Law in Action*, Temple Law Review, 87:93.

[108] The *Carnegie Triple* (especially its emphasis on having an active and interdisciplinary mind) is one of the expressions of the connection between legal realism and transaction cost economics, which goes a step forward in refining and operationalizing legal realism by inviting scholars to be disciplined and concrete in their proposals.

[109] As analyzed in the third chapter, this thesis views the treaties between the states as contracts with certain of these treaties, namely international investment treaties, resembling specifically relational contracts.

[110] Llewellyn, K. (1931), *supra* note What Price Contract? An Essay in Perspective, at 737. Emphasis added.

dimensions that distinguish transactions are uncertainty, frequency, and the degree to which transaction-specific assets are required.[111]

The contracts described below are placed along this three-dimensional spectrum and classified accordingly as classical, neoclassical, or relational. The different attributes of contracts depending on their categorization along this spectrum are important for their enforcement, and particularly their adaptation to changing circumstances. The relationship between the three dimensions of the spectrum along which contractual transactions are spread (that is, uncertainty, frequency, and asset specificity) and the three types of contracts analyzed below (i.e. classical, neoclassical and relational) can be preliminarily summarized by means of the simple graph below. As the graph depicts, as one moves from simple, classical contracts to complex, long-term, relational contracts all three dimensions of uncertainty, frequency and asset specificity increase.

Figure 1 *The Classification of Contracts*

		Investment Characteristics		
		Nonspecific	**Mixed**	**Idiosyncratic**
Frequency		**Market Governance (Classical Contracting)**	**Trilateral Governance (Neoclassical Contacting)**	
	Recorrect		**Bilateral Governance**	**Unified Governance**
			(Relational Contracting)	

[111] Williamson, O. (1979), *supra* Transaction-Cost Economics: The Governance of Contractual Relations.

b) Classical Contracts

Classical contracts match the needs of discrete, one-shot transactions, most often taking place between strangers operating in a market. The emphasis of classical contract law is on discreetness and "presentiation",[112] meaning the focus on materializing a transaction in the present place and time and avoiding its projection into the future. The economic counterpart of "presentation" is contingent-claims contracting, which entails comprehensive contracting, whereby all future contingencies are detailed and allocated between the parties in terms of the risk of their likelihood to materialize.

There are several legal means to achieve "presentiation". First, the identity of the parties to the transaction is irrelevant, thus corresponding to the "ideal" market transaction in economics. Second, the agreement is carefully delimited and there is a predominance of formal over informal terms. Third, the remedies are equally prescribed in narrow and highly predictable terms. Moreover, third-party participation, for example through arbitration or mediation, is discouraged.[113] In a nutshell, the emphasis herein is on legal rules and formality rather than legal standards and the parties' contractual relationship in its entirety.

In summary, classical contracts are simple contracts placed at the lowest grade in the three-dimensional spectrum of "uncertainty-frequency-transaction specific assets". They are in other words certain, one-shot contracts, which involve the investment of non-specific assets that can be easily redeployed elsewhere in the open market.

c) Neoclassical Contracts

Complete "presentiation" does not match the attributes and needs of all transactions. For long-term contracts performed in conditions of uncertainty the prediction of all future contingencies or the appropriate adaptations to address them is prohibitively costly. Moreover, as changes in the states of the world are usually ambiguous, veridical disputes can be common, and opportunistic claims can make the verification of the parties' contrasting representations a hard task for the judges.

In this context of uncertainty and inherent contractual incompleteness, the governance method that can better address the changing needs of the parties is one of sequential and adaptive decision-making. The latter can be achieved through either internal or external governance structures. The first is the placement of the parties' exchange under common

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[112] See Macneil, I. (1978), *supra* note 89, at 862.

[113] See Williamson, O. *supra* note 100, at 236, 237. See also Arrow, K. (1958), *Essays in the Theory of Risk Bearing,* The Journal of Business, 47 (1): 96, at 121-134.

ownership and its ensuing hierarchical incentives and controls. In the context of public-private partnerships this means the establishment of joint ventures, or otherwise institutional public-private partnerships, in which the parties have joint ownership interests and thus joint control over sequential decisions.[114]

The second governance structure that can achieve the adaptation of the contract to the changing circumstances is the relation that *Macneil* calls neoclassical contracting.[115] There are two main features characterizing neoclassical contracts. The first is the existence of gaps in their planning. The second, related characteristic is the incorporation of processes and techniques into the contract, which serve to sequentially fill these gaps in accordance with the mutable needs of the parties instead of planning rigidly ahead for contingencies that are still uncertain at the time of contracting.[116]

In other words, neoclassical contracts account for uncertainty and inherent incompleteness through the pre-establishment of contractual processes that the parties will follow in order to adjust the terms of their contract to the altered circumstances. As such, this type of contracts falls in the middle of the aforementioned three-dimensional spectrum, meaning that they are characterized by more uncertainty, long-termism, and transaction-specific investments than classical contracts.

However, all these challenges can still be handled in the context of the contract itself, using contractual terms and provisions that manage the uncertainty and the transaction-specific investments of the parties with a view to governing sustainably their relationship in the long run. In this sense, they differ from the even more complex, relational contracts, which are positioned at the highest extreme of the afore-described spectrum.

The last important feature of neoclassical contracts regarding their potential for adjustment is the use of third-party assistance to resolve disputes before they escalate into court cases. In contrast to classical contracts, where formal rules and litigation take precedence over any adjustment mechanisms and the salvation of the relationship between the parties, neoclassical contracts serve to facilitate the amicable resolution of disputes through arbitration or mediation.

Lon Fuller points to the procedural differences between arbitration and litigation and the emphasis of the former on facilitating the amicable adaptation and the preservation of the

[114] According to the organizational economists' view, relational contracts are a second best in addressing the inherent incompleteness of the relevant transactions, as compared with vertical integration and the ensuing delegation of the sequential decision-making to hierarchy. See Baker, G., Gibbons, R. & Murphy, K. (2002), *Relational Contracts and the Theory of the Firm*, The Quarterly Journal of Economics, 117 (1): 39.

[115] See Williamson, O. *supra* note 100, at 237.

[116] See *supra* Macneil, I., at 865.

contract. He notes that arbitrators have wider and more flexible tools at their disposal, compared to courts, in terms of gathering evidence and examining witnesses. For example, as *Fuller* observes, the arbitrator has the possibility to use quick methods of education not open to the courts, such as the interruption of the examination of witnesses with the request that parties educate them, even informally, to the point that their testimonies become sufficiently clear to the arbitrator.[117]

The differences between the two settlement machineries illustrate the divergent features and needs describing the two types of contracts and particularly their distinct purposes. Whereas classical contracts focus on the strict enforcement of the formal rules regulating discrete transactions, neoclassical contracts and arbitration place more emphasis on the continuity of the relationship, which is fractured once a dispute reaches the litigation phase.[118]

d) Relational Contracts

Relational contracts go a step further in the aforementioned continuum, and they present, therefore, an even stronger case for the establishment of adjustment mechanisms facilitating their adaptation to the evolving needs of the parties. This category of contracts is typically characterized by extreme uncertainty, long-term duration, and transaction-specific investments dependent for their profitability and lasting success on the overall (both contractual and extra-contractual) relationship of the parties. All these elements deepen the problems arising from the inherent incompleteness of complex contracts.

The increasing complexity and duration differentiates this type of contracts from the previous category, that of neoclassical contracts. Unlike the latter, where the adjustment mechanisms are already prescribed in the original contract and judges are expected to refer to the original intent of the parties, the adjustment needed in relational contracts is hard to predict beforehand and evolves[119] in line with the entire relationship of the parties, as it has developed through time. In other words, adaptation itself is an ongoing and evolving process having as a reference point both the contractual and the extra-

[117] Fuller, L. (1963), *Collective Bargaining and the Arbitrator*, Retrieved from: http://www.naarb.org/proceedings/pdfs/1962-8.pdf, at 11-12.
[118] Friedman, L. (1965), *Contract Law in America*, Madison: University of Wisconsin Press, at 205.
[119] *Macneil* also bestows an evolutionary dimension to the distinction between neoclassical and relational contracts, by predicting already in early 1900s that the American legal system would move from neoclassical to relational patterns, away from the limitations posed by the classical scheme of discreetness and its structure based on full consent at the time of the initial contracting. See Macneil, *supra* note 137, at 885-886.

contractual elements of the parties' relationship, as it stands at the time that the adaptation is needed.

Similarly, the focus on the long-term sustainability of the relationship becomes even starker as relational contracts depart further from the model of discreetness characterizing classical contracts. Viewing the contract as a discrete, one-shot transaction is irrelevant in the context of relational contracts, where the relation resembles "a mini-society with a vast array of norms beyond those centered on the exchange and its immediate processes."[120]

Prior to elaborating on the characteristics of relational contracts and the tenets of relational contract theory applicable in the field of international investment law, the conclusion to be drawn from the above is that governance (especially adjustment) structures vary with the nature of the transaction. Simple and standardized classical contracts call for simple (if any) adjustment structures, whereas the complex, recurring, and non-standardized relational contracts present significant challenges in their governance. This is due to the idiosyncratic nature of the latter, involving the investment in transaction-specific human and physical capital that makes the relationship between the parties unique and non-deployable to alternative uses.

The economics of idiosyncrasy and the "fundamental transformation" of the transaction from an originally competitive one to a relationship of bilateral monopoly lie at the core of transaction cost economics.[121] What is to be emphasized herein is the importance of trust for the success of idiosyncratic, relational contracts. Developing governance structures that establish trust between the parties and prevent their tendencies to behave opportunistically is key to the long-term sustainability of relational contracts.

It is also a challenging enterprise, given the fact that both parties are strategically situated, in this condition of natural monopoly, to exploit each other by aiming at appropriating the biggest size of the pie resulting from each change of their contractual terms. The following section elaborates on the structures that contribute to limiting opportunism and facilitating the good-faith adaptation of the relational contract to the benefit of both parties and the ultimate survival of their relationship.

[120] Id., at 901.

[121] See *supra* Williamson, O., at 61: "Contrary to earlier practice, transaction cost economics holds that a condition of large numbers bidding at the outset does not necessarily imply that a large numbers bidding condition will prevail thereafter."

3. The characteristics and the governance of relational contracts

a) Characteristics

It is important to note in advance that there is no universal definition of "relational" contracts, and consequently there is no distinct body of law specifically regulating relational contracts.[122] However, there are several characteristics that are common in this type of contracts. They all revolve around the relationship of the parties and its evolution.[123] The focus herein is on the characteristics of relational contracts that demonstrate the particular challenges that these contracts present for the governance of the parties' relationship, namely its good-faith adaptation to the changing circumstances and the economization on the transaction costs of bounded rationality and opportunism.

Relational contracts are complex, long-term, and inherently incomplete agreements. Moreover, unlike classical contracts, which include clearly defined and circumscribed legal rules, relational contracts usually include vague standards instead. In this respect, they also go a step further than neoclassical contracts, which also include standards but of a less vague character.[124] The emphasis on "standards", such as "good faith", the "reasonable expectations of the parties", and "fair and equitable treatment" is one of the core characteristics of relational contracts that make their rationale applicable to international investment treaties, where the use of standards, such as fair and equitable treatment, is also pervasive.

These characteristics are particularly relevant for the interpretation of investment-treaty standards, when a breach of the latter is argued on the basis of the renegotiation and adaptation of the underlying contract. The argument herein is that the same principles resulting from the characteristics of relational contracts underpinning their renegotiation and adaptation shall also apply to the interpretation of investment treaties, when the issue of a contractual renegotiation is under dispute. The actual nature of investment treaties as relational contracts containing dynamic obligations, and the resulting implications for the use of the proper (evolutionary) interpretative methods in adjudicating treaty-based disputes are further analyzed in the third chapter.

The two main features of relational contracts that pose challenges for their adaptation are their longevity combined with their inherent incompleteness. Each of the two features

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[122] Eisenberg, M. (1999), *Why there is no law of relational contracts*, Northwestern University Law Review, 94 (3): 805, at 813-815.

[123] Id., at 816: "The obvious definition of a relational contract is a contract that involves not merely an exchange, but also a relationship, between the contracting parties."

[124] Cheung, S.O. (2007), *Trust in Cooperative Contracting in Construction*, City University of Hong Kong Press, at 45.

creates distinct issues for the governance of contractual transactions but their combination magnifies these challenges significantly, thus making the establishment of transaction-specific governance structures necessary.[125]

More specifically, long-term contracts are most often renegotiated in an environment of asymmetric or symmetric but unverifiable information, or under conditions of moral hazard.[126] Moral hazard can occur due to the inter-temporal risk-sharing during the long duration of a contract[127] and the potential attempt of either of the parties to shift part of the risks to the detriment of its counterparty, by taking advantage of the existence of sunk investments and the ensuing situation of bilateral dependency in which the contract operates.[128]

The phenomenon of asymmetric information is the usual result of the principal-agent relationship between the contractual parties. This is the type of relationship developed in concession contracts, where the host state concedes the management and control of the privatized utility to the investor. The main problem that asymmetric information creates is the fact that it makes the performance of the contract "non-observable" to the counterparty. For example, information about the concessionaire's production costs is often unobservable.[129] Similarly, the actual reasons and effects of renegotiation (a process itself often unregulated and non-transparent) are also hard to observe. Common regulatory failures, institutional weaknesses, and the complex corporate structure of multinational corporations can make the concessionaire's performance hard to observe.

Consequently, the governance structure appearing as necessary to address information asymmetry and the non-observability of the parties' behavior is one that increases the visibility and transparency of their behavior. Such transparency is essential especially during a renegotiation and its inherent risks for the unfair frustration of the initial allocation of risks, and the overall economic equilibrium of the contract. As aforementioned, the last chapter will elaborate on the ways that investment arbitration can use rules of evidence to enhance the visibility of the parties' behavior and limit the hazard of opportunistic renegotiations.

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[125] See Williamson, O., *supra* note 136, at 250.

[126] Hviid, M. (1999), *Long-Term Contracts and Relational Contracts*, in: De Geest, G. (Ed.), Encyclopaedia of Law and Economics, Elgar Online.

[127] De Geest, G. (2011), *Contract Law and Economics*, Encyclopaedia of Law and Economics, Elgar Online, at 321.

[128] Id., at 14: "legal protection may be necessary to curb the moral hazard problem in situations of sequential investments, where the first party to make an investment may be forced to accept less favorable terms under the threat of losing what she paid in reliance if the other party breaks off the negotiations." The emphasis herein is on the sequential nature of investments and the consequent development of a contractual relationship of dependence between the parties, as all the more sunk investments take place.

[129] Schwartz, A. (1992), *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, The Journal of Legal Studies, 21 (2): 271, at 280.

The importance of the transparency of renegotiation as a central issue in many infrastructure disputes is aligned with (and is an essential part of) the general debate on enhancing the transparency of arbitral tribunals adjudicating investor-state disputes. Moreover, by contributing to the long-term sustainability of the investment contract, arbitration can fulfill its role as a global governance mechanism[130] that will contribute to the maintenance of healthy working relations among foreign investors and host states and, ultimately, the economic development of the latter.

In addition to the risk of the "non-observability" of the parties' contractual behavior due to information asymmetry, the "non-verifiability" of their conduct to third parties, namely the arbitrators, is another risk often undermining the good-faith governance and renegotiation of the contract. Non-verifiability results from the costs and difficulties of proving a fact to the court or arbitrator. Information hard to verify to a third party can render the contract legally unenforceable.

The non-verifiability hazard is even higher in the case of renegotiations, which take place outside of the framework of the contract's terms and involve a radical change of the contract and of the original distribution of risks. This extra-contractual dimension of renegotiation requires that the arbitrator looks not only at the "four corners" of the agreement but also at the overall relationship of the parties as it has developed, and especially the motives, reasons, and results of a renegotiation. Proving to an arbitrator that a renegotiation was "in good faith" or "reasonable" or consistent with the "best efforts"[131] of the parties to make their relationship work, requires the appropriate evidence and, especially, burden of proof (that should fall on the party that initiated the renegotiation).

In short, in order for a deviation to be punishable, it must also be "observable" to the counterparty, the rights of which are violated, as well as "verifiable" to the third party (herein the arbitrator) called to ultimately enforce the agreement or decide on the breach of a rule. Provided that these two conditions are fulfilled, "credible commitments"[132] can be made between the players, who will thus have an incentive to cooperate to obtain a profit-maximizing outcome for both rather than a non-cooperative Nash equilibrium of the one-period game.

Credible commitments and their counterpart, credible threats, are an essential part of relational contracts, where specialized, sunk investments are involved. Their central tenet

[130] On the role of investment arbitration as global governance see Radi, Y. (2014), *Balancing the Public and the Private in International Investment Law*, in: Muir Watt, H. & Fernández Arroyo, D. (Eds), *Private International Law and Global Governance*, Oxford Scholarship Online.
[131] All these terms are standards commonly used in relational contracts.
[132] Williamson, O. (1983), Credible Commitments: Using Hostages to Support Exchange, The American Economic Review, 73 (4): 519.

is that the use of “hostages” to support exchange in a “private ordering” setting is more efficacious to sustain relational, specialized contracts than simple recourse to a formal external forum, namely the court, according to the legal centralism tradition. In the context of “private ordering” the parties themselves devise specialized governance structures that may deviate from the general rules that courts or other state organs apply. These specialized governance structures, which may include self-enforcing mechanisms such as informal renegotiations or incentive structures within the broader exchange relationship of the parties[133], or recourse to specialized arbitration instead of the generic judicial mechanism, are better tailored to address the needs of the parties to an idiosyncratic contract than nonspecific mechanisms applicable to standardized contracts.

In this highly specialized context, “credible commitments” are necessary to enforce trust and cooperation. In the case of the renegotiation of concession contracts, what would count as “credible commitment” or “hostage” to foster good-faith renegotiations is a transparent procedure including the submission of a detailed plan explaining all the parameters of the renegotiation, especially its reasons and expected effects, and the supervision of the process by a third-party mediator.

Apart from the endogenous[134] risks of the non-observability and non-verifiability of the parties’ conduct, the inherent incompleteness of relational contracts is yet another complicating factor in achieving a balanced, good faith renegotiation. Unforeseen contingencies are exogenous risks that occur during the life of the contract, and make gap-filling mechanisms a necessary component of relational contracts. *Goetz* and *Scott* consider incompleteness and the ensuing necessity for filling gaps a central feature of relational contracts.[135] They argue that what makes a contract relational, is that there are uncertain states of the world that cannot be defined *ex ante*, thus making complex adaptations a necessary mechanism in the governance of this type of contracts.

In summary, relational contract theory can be summarized in three propositions, first articulated by *Macneil*. First, every transaction is “embedded” in complex relations

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[133] On this broader dimension of relational contracts, i.e. the existence of a wider relationship between the parties that includes more exchanges, see Post, A.., *supra* note 103, whereby it is explained why foreign investors that had a diversified portfolio in Argentina, thus investing in its overall economy and engaging in a broader contractual relationship with the state, fared much better than multinational companies that only held a short-term utility contract.

[134] Non-observability and non-verifiability are endogenous contractual risks because they are raised from within the system, by the strategic behavior of the parties themselves. Generally, a risk that depends on the parties’ behavior and gives incentive for moral hazard or hold up situations is an endogenous risk. See Shin, H.S. (2008), *Lecture on Endogenous Risk at Princeton University*, Retrieved from: https://www.ethz.ch/content/dam/ethz/special-interest/mtec/cer-eth/cer-eth-dam/documents/teaching/short-courses/syllabus-Shin.pdf, and Kobayashi, K. & Onishi, M. (2006), *Risk-Sharing Rule in Project Contracts*, Retrieved from: http://www.irbnet.de/daten/iconda/CIB12861.pdf, at 382.

[135] Goetz, C. & Scott, R. (1981), *Principles of Relational Contracts*, Virginia Law Review, 67 (6): 1089, at 1091.

between the parties as well as in broader societal norms. "Embeddedness" means that exchanges occur in the context of evolving relationships rather than a static transactional environment, as classical and neoclassical contract theorists assume.[136] In game-theory terms, the object of contracting in such an environment of repeated interactions is to define a "cooperative relationship" between the parties rather than a mere risk allocation between them, as traditional contract theory predicts. Such cooperative behavior is economically justified by a broader temporal definition of "utility" according to which parties stand to draw long-term benefits from the successful implementation of their long-term contract, as long as they manage the transactional hazards of bounded rationality and opportunism.

Second, determining the parties' "intent" in this context requires an evaluation of all the essential elements of the relationship instead of a static evaluation of the "four corners" of the agreement. This means that "context" and cooperation constitute indispensable elements of the interpretative exercise. As a result, any interpretation of the contract has to include a contextual analysis of the parties' relationship. On the other hand, the parties' "intent" is not to be confused with their "consent", which, according to the third proposition of the relational contract theory, is an element secondary to the "relationship".[137]

This means that in long-term and inherently incomplete exchanges, as relational contracts are, the parties' "bounded rationality" precludes full, *ex ante* consent to all future contingencies that will materialize. The emphasis herein is, instead, on their "intent" to enter into a cooperative relationship requiring them to implement necessary adaptations to their contract, as circumstances change or new information becomes available.

b) Governance and judicial strategies

i) The role of the law in the governance of relational contracts

As aforementioned, a central feature characterizing the nature and the operation of relational contracts are specialized (idiosyncratic) governance structures that facilitate the adaptation of the contract to the evolving relationship of the parties. According to the model of "adaptive governance", the emphasis is less on fully determining at the outset

[136] Macneil, I. (2000), Relational Contract Theory: Challenges and Queries, Northwestern University Law Review, 94 (3): 877, at 881.

[137] See *supra* Wessel, at 153-154.

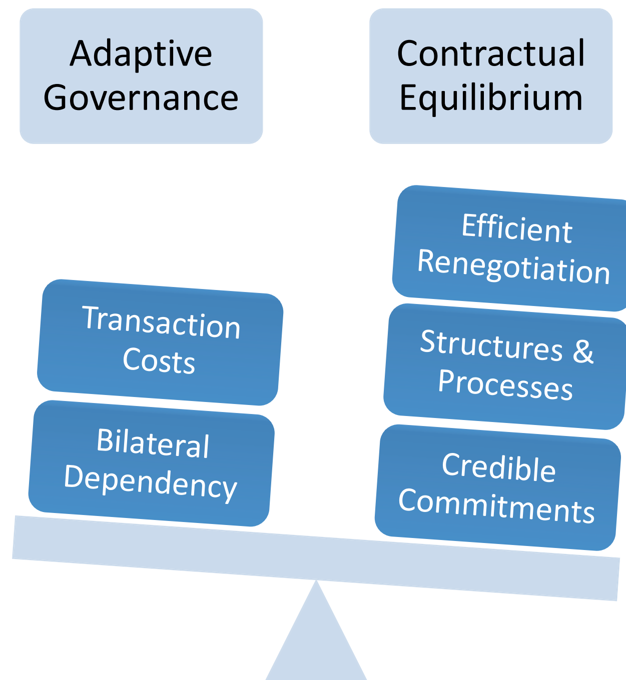
the substance of the contractual relationship than setting up the processes[138] and structures that will govern the relationship in the long run. The main goal is to establish processes that will regulate the necessary adaptations in a way that economizes on the transaction costs of bounded rationality and, especially, opportunism, which are inevitable in the context of inherently incomplete and transaction-specific contracts.

Addressing the hazards of the non-observability and non-verifiability of the parties' behavior is central to enforcing the necessary cooperation that will keep the relational contract alive in the long run. Cooperation (along with role integrity and embedded-ness in the social matrix) is a central norm of relational contracts,[139] and crucial for their survival as forms of repeated interactions. According to the folk theorem for repeated games, a repeated interaction may enable cooperation, because of the potential for a current deviation from the rules of the game to be punished at the subsequent instance of interaction.

The following graph depicts the delicate balance that international investment law is called to strike in order to achieve the adaptive governance of complex, relational contracts and maintain their economic equilibrium. On the one side of the scale lie the factors impeding the good-faith cooperation between the parties and the ensuing efficient renegotiation and adaptation of their contract. These are the transaction costs of bounded rationality (including inherent incompleteness and non-observability) and opportunism (including non-verifiability), which "flourish" in conditions of bilateral dependency, where idiosyncratic, relational contracts operate. On the other side are those parameters counterbalancing the negative effects of transaction costs and idiosyncrasy, namely credible commitments, the structures and processes supporting their implementation, and efficient renegotiation, as a result of such processes.

[138] See Macneil, I. (1974), *supra* note 99.

[139] Macneil, I. (2000), *Relational Contract Theory: Challenges and Queries*, Northwestern University Law Review, 94 (3): 877.



Although there is no single body of relational contract law *stricto sensu*, the afore-described common characteristics of relational contracts create the need for legal rules emphasizing the importance of the relationship in contractual implementation. The relational contract literature has put forward several rules able to address the challenges that relational contracts pose for their long-term governance and enforcement. Among those are rules imposing on the parties a broad obligation to perform in good faith, and rules that broaden the kinds of changed circumstances that excuse non-performance or the renegotiation and amendment of the contract.

More specifically, provisions enacting a duty to bargain in good faith to make equitable adjustments when circumstances change, and rules permitting courts to adapt or revise contractual terms so as to force the parties to share losses (even at the expense of one of the parties' profits) are rules apt for the implementation of relational contracts. More generally, relational contracts call for rules treating such contracts like partnerships rather

than mere exchanges between parties with divergent (even conflicting) interests, and aiming at holding the relationship together.[140]

In a nutshell, the emphasis in this type of contracts is on the "relationship" between the parties and its governance in the long run with a view to filling the gaps caused by the contract's inherent incompleteness. According to *Macaulay*, two principles of behavior are central in achieving effective, gap-filling governance; solidarity and reciprocity. These principles serve to facilitate the endogenous cooperation of the parties in an environment of repeated interactions translated, in economics terms, into the folk-theorem for repeated games. The folk theorem is based on the idea that in a repeated game, where contractual breaches are both observable and punishable, players have a stronger incentive to cooperate than deviate, because the joint surplus from their cooperation is higher than the short-term gain from deviation.

Apart from *ad hoc* legal rules, the absence of a solid body of relational contract law leaves significant space and discretion to the courts to play an active role in the governance of relational contracts. Especially arbitration, as a form of global governance conferring upon arbitrators wider quasi law-making powers than those of national judges, allows for a more pragmatic approach to the resolution of disputes that involve the renegotiation and adaptation of contracts to changing circumstances. Developments in the international-contract-law doctrine point to the wider role of arbitrators in facilitating the adaptation of complex investment contracts by taking into consideration not only legal rules but also behavior-linked standards, particularly of good faith, fairness, and reasonableness, as well as of the cooperation between the parties.

ii) The role of the courts in the governance of relational contracts

The two problems described above demonstrate the importance of making the implementation of the contract by the parties both observable to each other and, even more importantly, verifiable to a third-party that is called to adjudicate their disputes. The focus herein (and even more in the last part) is on the design of proper governance structures that allow for the observability and verifiability of contractual renegotiations and their reasons. At the heart of these governance structures lie the rules on presumptions and the allocation of burdens of proof between the parties.[141]

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[140] See Eisenberg, M., *supra* note 146, at 818. In the case of contracts establishing public-private partnerships - as concession contracts are - the partnership element thus exists by definition.
[141] See Goetz, C. & Scott, R. *supra* note 160, at 1147-1150.

As analyzed further below, the allocation of evidentiary rules is key to forcing the revelation of information by the parties to the court and, accordingly, influencing the parties' incentives to share information that is material for the fulfillment of their contractual obligations. Non-verifiability amplifies the risk of the fabrication or manipulation of evidence by an opportunistic party that takes advantage of the difficulty of the court to verify certain information. Moreover, the judges' limits of detecting facts accurately contribute to making judicial enforcement costly and imperfect.[142] Thus, in order to avoid the transaction costs of erroneous judicial fact-finding and the litigants' opportunism, evidentiary rules that limit these transaction costs are needed.

Inherent incompleteness also complicates the balanced, good faith renegotiation of relational contracts. Courts have a substantial role to play in filling gaps in incomplete, relational contracts. Relational and law-and-economics scholars agree both that incompleteness is common and on the judicial strategies to deploy to address it.[143] They argue that judges (or arbitrators) have to identify "norms" which state-supplied terms can be derived from. However, relational scholars disagree over the source of these gap-filling norms. Some argue for the "external" relational approach, meaning that judges should use norms that transcend the relationship, guided by society's sense of fairness, distributive justice, and procedural propriety.

Another group of relational contract scholars insists on the "internal" relational approach, according to which the gap-filling norms shall derive from the norms of the relationship, as they have developed in the course of the parties' interaction. According to this perspective, the contractual relationship is an evolving process during which the parties develop "expectations" about each other's obligations or make "commitments"[144] to each other.[145] The contractual relationship thus arises as the backbone of the contract, together with the behavioral principles of solidarity and reciprocity.[146] The emphasis on a solidary and cooperative relationship between the parties is thus an indispensable feature of relational contracts, and the repeated interaction of the parties aims at curbing the latter's tendency to behave opportunistically.

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[142] Sanchirico, C.W. & Triantis, G. (2008), *Evidentiary Arbitrage: The Fabrication of Evidence and the Verifiability of Contract Performance*, The Journal of Law, Economics, & Organization, 24 (1): 72.

[143] Even Posner, a typical law-and-economics scholar admitted in a Symposium on the future of the relational contract that most contracts are relational and their relational character influences the way courts are expected to resolve conflicts arising from their implementation. See Posner, E. (2000), *A Theory of Contract Under Conditions of Radical Judicial Error*, Northwestern University Law Review, 94:749, at 4: "this, I hope, will be understood as a vindication of the relational contract approach" […] this is a first step to understanding the role of courts, once we acknowledge that we live in a relational world."

[144] The use of the same terminology makes even clearer the connection between relational contract theory and transaction cost economics. On the role of credible commitments in the evolution of the contractual relationship, see Williamson, O. *supra* note 157.

[145] See Schwartz, A. *supra* note 154, at 275.

[146] On the core importance of these principles for the success of relational contracts, see the series of papers by Ian Macneil, 1974; 1978; 1981a; 1987a.

In order to operationalize the "internal" relational approach, a judge can view the parties' relationship as a mini-society producing its own values, which can serve as criteria for the resolution of the ensuing disputes. In a similar way, the judge shall draw decisional criteria based on the parties' expectations to maximize their utility. In this last sense, there is an overlap in the reasoning of relational and law-and-economics scholars, as they both pursue efficient decisional norms that would maximize the parties' utility and minimize their transaction costs.[147]

The "internal" relational view is clearly resonant of the emphasis of investment tribunals on the "legitimate expectations" of the parties, as an element of the "fair and equitable treatment" standard. The emphasis of both relational contract theory and investment arbitration on the "legitimate expectations" of the parties demonstrates the similarity of the two approaches and constitutes an argument in favor of the application of relational contract theory to the interpretation of investment-treaty standards, namely the standard of fair and equitable treatment. In the context of relational contracts legitimate expectations are dynamic obligations that evolve throughout the life of the contractual relationship and not static obligations that are frozen at the moment of the signing of the contract between the host state and the investor.[148]

In this context of incompleteness and inevitable gap filling, adjustment processes arise as the central governance structure for achieving the necessary, sequential adaptations of the contractual relationship. Unlike with classical and neoclassical contracts, the reference point for adjustment in relational contracts is the whole context of the entire relation as it has developed until the moment of adjustment, and not the original agreement. Professor *Chayes*[149] and Professor *Macneil*[150] have developed a model focusing on the judicial processes of the adjustment of relational contracts.

In this judicial model - also called "public law litigation" - the scope of the dispute is not exogenously given by contract terms but is shaped by both the parties and the adjudicator, and the entire relationship as it has evolved. Moreover, the party structure is not rigidly bilateral but may include other affected stakeholders (such as consumer associations). What is more important, the remedial lines are not restricted to compensation but are broader, more flexible, and forward looking, taking also into account the interests of third parties, which the award produces externalities on. They are also not imposed top-down, but are negotiated and mediated.

[147] See Schwartz, A. *supra* note 154, at 276-277.
[148] Schreuer, C. & Kriebaum, U. (2009), *At What Time Must Legitimate Expectations Exist*? in: Werner, J. & Ali, A. H. (Eds), A Liber Amicorum: Thomas Wälde: Law beyond Conventional Thought, CMP Publishing.
[149] Chayes, A. (1976), The Role of the Judge in Public Law Litigation, Harvard Law Review, 89 (7): 36.
[150] See Macneil, I. (1978), *supra* note

Similarly, the dispute-resolver is not passive, simply declaring the breach or non-breach of governing rules, but is active and bears responsibility both for credible fact finding and for shaping the dispute processes that can ensure a fair and viable outcome. In a related way, the subject matter of the dispute and the ensuing effects of the decision are not constrained to the adjudication of private rights between private parties. On the contrary, the subject is a grievance about the operation of the policies of the overall contractual relationship (especially the renegotiations involved). Moreover, it involves the exercise of law-making powers by the adjudicators and, equally, has wider implications not only for the parties directly involved but also for other stakeholders (for example, the consumers of the public utilities which had been under the control of the concessionaire).

It is evident that the "public-law litigation", as a relational system where a network of actors is (directly or indirectly) involved, and various sources of law are considered in the adjudication of disputes, contrasts starkly with the classical and neoclassical approaches to dispute resolution. In the classical and neoclassical adjudicatory systems the lawsuit is bipolar, affecting only the individuals involved, while the sources considered in establishing the substantive content of the disputed transaction are limited, and the remedies for resolving the dispute are narrow, revolving around polar rights rather than overall policies of the contractual relation.[151] As described below, investor-state arbitration fits the relational model of "public-law litigation", which produces significant externalities for third parties, and involves significant decision-making powers conferred to arbitrators.

iii) Investor-state arbitration as public-law governance

Relational investment contracts operate, in principle, under the auspices and in the shadow of international investment treaties. The treaty thus has an impact on the governance and the legal consequences of the underlying contracts. As a result, the one-shot game played at the level of a treaty dispute can have a decisive impact on the repeated games that have taken place at the level of the contract implementation.

Making a backward induction, this final, treaty game is crucial for the entire evolution of the parties' underlying contractual relationship and, consequently, also for the outcome of all the games that have taken place at the contractual level. For example, a behavior punished at the contractual level but affirmed at the treaty level would invalidate the effectiveness of a contractual punishment and, thus, pre-determine the outcome of the contractual games, especially of renegotiations. For this reason, and in order to increase the sustainability of contracts signed under the umbrella of investment treaties, arbitral

[151] See Macneil, I. *supra* note 137, at 891-893.

tribunals should take into consideration the contractual behavior of both parties while adjudicating treaty disputes involving contractual renegotiations.

The relational model of "public-law litigation" fits the nature and needs of the investor-state dispute settlement, which produces significant externalities for third parties, particularly the citizens of the host state. The public law approach to international investment arbitration is an emerging paradigm. According to the public law paradigm, the characteristics and challenges of investment arbitration can be fully grasped neither by public international law nor by commercial law alone. On the contrary, a "hybrid" approach encompassing elements of both systems is necessary in order to achieve a better balance between the interests of the investor and the host state.

This evolving paradigm, also called "Lex Mercatoria Publica" aims at achieving the necessary realignment between the conflicting public and private interests through a comparative public law methodology that instills public law values in the thinking and modus operandi of investment arbitrators.[152] For instance, the tribunal in *Total v. Argentina* followed such a methodology. It observed that "in determining the scope of a right or obligation Tribunals have often looked as a benchmark at international or comparative standards."

The tribunal added that "indeed, as is often the case for general standards applicable in any legal system (such as "due process"), a comparative analysis of what is considered generally fair or unfair conduct by domestic public authorities in respect of private firms and investors *in domestic law* may also be relevant to identify the legal standards *under BITs*. Such an approach is justified because, factually, the situations and conduct to be evaluated under a BIT *occur within the legal system and social, economic and business environment of the host State.*"[153]

Arbitration between private investors and states is, thus, not a simple means of settling individual disputes. On the contrary, it involves the exercise of public authority, thus being a mechanism of global regulatory governance. Governance arises as an alternative to hierarchical organization, as is the case with the management of relational contracts. The governance role of investor-state arbitration emanates from the "cooperative

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[152] Schill, S. (2013), *The Public Law Paradigm in International Investment Law*, Retrieved from: https://www.ejiltalk.org/the-public-law-paradigm-in-international-investment-law/

[153] See *Total v. Argentina,* ICSID No. ARB/04/1, Decision on Liability, 27 December 2010, para 111. Emphasis added.

paradigm" of state-market relations that substitutes public-private partnerships for the unilateral exercise of public power.[154]

Particularly in the area of public services, such as infrastructure, states depend increasingly on private finance and expertise, often of foreign investors. These public-private partnerships influence not only legislation and the administration of public services but also the adjudication of disputes between states and foreign investors, particularly through the privatization and internationalization of such disputes.[155]

The characteristics of investor-state arbitration as a form of "public-law litigation" make the system inappropriate for the use of classical-contract-law principles, with their emphasis on fixed rights and obligations set in the original investment contract[156] and with little regard for the bounded rationality of the parties resulting from the inherent incompleteness of complex concession contracts and the ensuing necessity to adapt their relationship to changing circumstances.[157]

Nevertheless, as demonstrated in the examination of the relevant case law below, arbitral tribunals have often followed the axiomatic and deductive approach of classical contract law, which does not allow for novel doctrinal interpretations on the basis of policy considerations or empirical evidence. Similarly, they have adopted the objective and standardized principles of classical contract law, applying the ordinary-meaning rule of interpretation without always paying due consideration to the individual circumstances of the parties, and rejecting such individualized rules such as unconscionability, the duty to negotiate in good faith, and subjective principles of interpretation.[158]

Similarly, little regard has generally been shown to the transaction costs of bounded rationality and opportunism, particularly the strategic behavior of the parties in making their contractual conduct non-observable or non-verifiable to the arbitrators. Relational contract theory can help alleviate these transaction costs and the destabilizing tensions

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[154] Schill, S. (2013), *Transnational Private-Public Arbitration as Global Regulatory Governance: Charting and Codifying the Lex Mercatoria Publica*, Retrieved from: http://www.mpil.de/en/pub/research/archive/erc-project.cfm

[155] See Schill, S., *supra* note 65.

[156] An example of this static, classical-contract-law approach of ISDS is the time at which the "legitimate expectations" of the investor are evaluated. Often investment tribunals have found that the moment these "legitimate expectations" are created is when the investment contract is originally signed. They have thus taken a static perspective on the matter and the ensuing rights of the investor.

[157] The last chapter, which examines the case law on the alleged breach of FET as a result of the renegotiation of investment contracts, elaborates more on this mismatch between the relational characteristics of ISDS and the public-law purposes it serves, and the classical interpretative methods and judicial strategies that arbitral tribunals have often deployed so far.

[158] Eisenberg, M., *supra* note 146, at 807-808

between the public and private interests often at play in the resolution of investor-state disputes.[159]

In addition to the aforementioned features of the public-law litigation, which make this relational adjudicatory model suitable for settling disputes between states and investors, overall, the tenets of relational contract theory are suitable for application to investor-state arbitration. Particularly the emphasis of relational contract theory on dynamic standards and adaptation processes instead of fixed-set rules, and the relevant need for evolutive interpretative techniques in applying these standards fits the open-textured and evolving standards of international investment treaties.

Standing in opposition to classical contract law, with its static, axiomatic, and deductive nature, relational contract theory is open, dynamic, and inductive. Unlike the former, which provides standardized rules for one-off transactions taking place between strangers in an anonymous market, the latter focuses on ongoing relationships, often developed in a situation of bilateral monopoly.[160] Moreover, relational contract theory pays due attention to transaction costs and the complexities they create for the long-term success of the contractual relationship. Indeed, transaction cost analysis, that is, the identification of transaction costs relating particularly to information, monitoring, enforcement, and the renegotiation of the contract, is the first step of relational analysis.[161]

As opposed to classical contract law, in the core of transaction cost economics and relational contract theory lies the assumption that humans are rational actors, but only within the limits of bounded rationality and opportunism.[162] These two major behavioral factors characterize the conduct not only of the parties to a relational contract but also of external actors involved, including arbitrators.[163]

c) Concession contracts as relational contracts

i) Relational Contract as the New Public Contracting

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[159] Or, in the words of TCEs, a governance/judicial structure that matches the attributes of transactions/disputes in question. If these disputes are relational in nature, then also the judicial system addressing them must be based on relational methods of dispute resolution.

[160] See Eisenberg, M., *supra* note 146, at 812.

[161] See Macneil, I., *supra* note 137, at 890.

[162] On the contrary, the absolute rational-actor model of psychology is an assumption of classical contract law.

[163] Brekoulakis, S. (2013), *Systemic Bias and the Institution of International Arbitration: A New Approach to Arbitral Decision-Making,* Journal of International Dispute Settlement, 4 (3): 421. See also Rogers, C. (2014), *The Politics of International Investment Arbitrators,* Santa Clara Journal of International Law, 12 (1): 223.

Concession contracts fall under a new form of public governance establishing hybrid organizational structures for the provision of public services. These hybrid structures involve partnerships between the public and the private sectors for the achievement of a common objective. These partnerships establish a form of reflexive governance fostering relational economic exchanges between the public and private partners, while they are working together to attain the agreed objective.

Macneil's relational contract theory offers the "common contract norms" necessary for the survival of a public-private partnership, namely integrity, reciprocity, flexibility, contractual solidarity, the protection of the legitimate expectations of both parties, and the embeddedness of the contractual relationship in the social matrix. In this way, *Macneil* emphasizes the behavioral aspects of a contract, as opposed to only its strict legal definition.[164]

"Relationality" is not in itself a sufficient condition for contracting out successfully the provision of public services. Whereas the development of a cooperative relationship between the state and the investor is a *sine qua non* for the sustainable governance of a concession contract, it shall develop within the appropriate "organizational architecture".[165] This organizational setting is the framework within which the processes of collective learning and the adaptations of the concession contracts take place. It typically includes regulatory, contractual, and extra-contractual structures that facilitate the cooperative implementation of the concession.

Such an organizational architecture is essential not only for the governance of concession contracts, but also for the institutional design of the investor-state dispute settlement, which is still in the making. The investor-state dispute settlement regime resembles concession contracts, in the sense that it is also a hybrid, public-private regime lying at the intersection between public-law litigation and commercial arbitration and calling for a delicate balance between the interests of the investor and those of the host state.

ii) The tension between the stability and the adaptability of concession contracts

At the heart of the hybrid, public-private nature of concession contracts lies the tension between the need for the rigidity and stability of contractual terms and their adaptability to the inevitably changing circumstances. On the one hand, they are commercial contracts

[164] Macneil, I. (2003), *Relational Contract Theory after a Neoclassical Seminar*, in: Campbell, D., Collins, H., Wightman, J. (Eds.), *Implicit Dimensions of Contract: Discrete, Relational, and Network Contracts*, Hart Publishing, at 212.

[165] See Vincent-Jones (2006), *The New Public Contracting: Regulation, Responsiveness, Relationality,* Oxford University Press, at 20-21.

expected to produce profits for the investor, and are subject to the changing circumstances of the socio-economic and political environment in which they are embedded.

On the other hand, as public contracts, concession contracts are drafted in terms as rigid as possible, in order to avoid any allegations of corruption and tie the government's hands in providing "credible commitments" to the private investor. Moreover, as regulatory contracts, they produce externalities for third parties, on behalf of which the government delegates the management and control of the public utility to a private investor. Consequently, third parties have an interest in monitoring the implementation of concession contracts, in order to limit corruption and bribery.

However, third parties are not disinterested either vis-à-vis the implementation of the contract, but are also prone to behaving opportunistically. Being biased, interest groups provide information only when it is to their benefit, and may have the incentive to challenge the probity of a concession contract for political or economic motives, namely because they compete with the incumbent public agent in the political market, or because they would accrue economic benefits from a change of the concessionaire.[166]

Under the threat of being politically challenged, the public authority awarding a concession has the incentive to draft its contractual terms as specific and rigid as possible. For the same reasons of mitigating third-party opportunism, the parties are likely to agree equally on specific adjustment processes, including formal procedures of renegotiation. In a nutshell, the externalities that the privatization of a politically sensitive sector - that of utilities - produces makes concession contracts far more complex than similar (for example, construction) contracts between private parties.

Indeed, in an effort to balance stability with adaptability, concession contracts include highly specific and complex tariff adjustment clauses regulating both periodic and extraordinary price adjustments. These clauses aim at spelling out the contingencies justifying an adjustment in tariffs. Despite the complex mathematical formulas stipulating such conditions, in practice adjustment clauses have failed to deliver the needed balance between specificity and adaptability.

Notwithstanding the efforts of the parties to draft a highly specific contract in order to mitigate third-party (or the counterparty's) opportunism, the actual nature of concession contracts is highly relational. The failure of price adjustment clauses to serve the need for

[166] Spiller, P. (2011), *Basic Economic Principles of Infrastructure Liberalization: A Transaction Cost Perspective*, in: Finger M. & Kunneke, R. (Eds), *International Handbook of Network Industries*: *The Liberalization of Infrastructure*, Edward Elgar Publishing, at 16.

the adaptability of concession contracts to changed circumstances attests the *de facto* relational character of this type of contracts.

Infrastructure projects bear all the characteristics of relational contracts, particularly long-termism, inherent incompleteness, idiosyncratic sunk investments, and changing needs of the parties as the project evolves. Consequently, this incongruity between the *de jure* and *de facto* nature of concession contracts (or, in legal-realism terms, "law on paper" and "law in action") creates tensions both between the parties and between them and third parties, when the time for the inevitable adaptation of the concession contract comes.

Another indication of the relational nature of concession contracts is the fact that prior to the formation of the contractual public-private partnership both the ownership and the control of the utility were vertically integrated within the public sector. With the separation of ownership from control, by assigning the latter to the private concessionaire, trust and cooperation, as the core elements of relational contracting become substitutes for the previously vertical and hierarchical decision-making.[167]

The starkest evidence that concession contracts are relational in practice is their frequent renegotiations. Had the adjustment mechanisms (particularly the price adjustment clauses) incorporated in the contract sufficed, the radical modifications of the contract through renegotiations not provided for in the original contract, would not have been so perverse in practice. These renegotiations taking place outside the framework of the contract show that the implementation of the concession contract depends not only on its explicit terms but also on the wider relationship of the parties and the norms and conduct that they have developed, as well as their changing circumstances. There is a wealth of literature in Economics analyzing incomplete contracts (as opposed to the legal literature, which is following the matter at a much lower pace - while neglecting it almost entirely in the case of international investment arbitration).

Seminal research has been that of *Hart* and *Moore*. Both in their paper on the foundations of incomplete contracts, and in applying incomplete contract theory to property rights and the nature of the firm the authors show the strong connection between contract theory and corporate governance. Nevertheless, both factors (incomplete contracting and corporate governance) have been entirely overlooked in international investment arbitration, and in particular the adjudication of treaty disputes ensuing from contractual failures.

[167] Adler, P. (2001*), Market, hierarchy, and trust: the knowledge economy and the future of capitalism*, Retrieved from: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.568.5719&rep=rep1&type=pdf See also Granovetter, M. (1985), *Economic Action and Social Structure: The Problem of Embeddedness,* American Journal of Sociology, 91 (3): 481.

Hart and *Moore* observe that only in an ideal world parties would be able to write a contingent contract specifying all responses to all possible future states that may materialize. Indeed, when the number of such contingencies is very large or hard to predict in advance (as is by definition the case with complex, long-term contracts), the transaction costs for drafting a complete contract are prohibitively high. As a result, the parties would opt for an incomplete contract instead, and would seek to renegotiate it, once a contingency would materialize.[168]

In addition to the non-observability (at least at a non-prohibitively high cost) of certain contingencies *ex ante* - summarized as the bounded rationality of the parties - the non-verifiability of material information is also one of the main sources of contractual incompleteness. *Grossman* and *Hart* have been pioneers in developing a model explaining incomplete contracts by controlling for the non-observability factor. Their assumption in this model is that some information is observable by the parties, but not verifiable to a third party, namely the court.[169]

Using the language of economic contract theory, verifiability refers to the feasibility of establishing the truth to the court.[170] Of course, as *Scott* and *Triantis* have highlighted, there is an important distinction between criminal and civil courts.[171] In contrast to criminal cases, where the standard of proof is objective and evidence should thus prove the claim beyond all reasonable doubt, in civil cases the courts weigh the evidence and make determinations of complex facts on the basis of the balance of probabilities.[172] In other words, the evaluation of evidence is relative rather than absolute.[173]

Verifiability thus has to do with the standards of proof and the rules of evidence used in a court or arbitral proceeding. The same, relative standard of proof required in civil cases can be considered as applicable in international investment arbitration, where tribunals have even more flexibility in requesting proof - including by means of discovery - and evaluating the relevant evidence presented by the parties. Non-observability and non-verifiability may of course also impact only one of the parties. It is such one-sided impact that lies at the heart of information asymmetries. Information asymmetries, in particular between the concessionaire and the regulator, are a common problem with public-private

[168] See *supra* Hart, O. & Moore, J. (1999), at 115.
[169] Grossman, S. & Hart, O. (1986), *The costs and benefits of ownership: A theory of vertical and lateral integration, Journal of Political Economy*, 94(4): 691, at 698.
[170] Sanchiciro, C. & Triantis, G. (2008), *supra* note 191, at 76. See also Lind, H. & Nyström, J. (2007), *supra* note 57, at 8.
[171] Scott, R. & Triantis, G. (2005), *Incomplete Contracts and the Theory of Contract Design*, Case Western Reserve Law Review, 56 (1): 187, at 198. The complexity of such distinction can arise in the context of international investment arbitration, in cases, for example, ensuing from sovereign debt, where bonds were claimed to be counterfeit, thus giving rise to a related criminal proceeding on the validity of the bonds.
[172] See Sanchiciro, C. & Triantis, G., *supra* note 106, at 24.
[173] See Scott, R. & Triantis, G, *supra* note 63, at 12.

partnerships, which leave the formal ownership with the state but assign the actual control of the concession to the private sector. Such delicate allocation of responsibilities can obviously create a tension between the inevitably divergent interests of the parties and the ensuing need to continuously strike an equilibrium between them.[174]

On the other hand, contractual incompleteness can also be the result of a conscious choice of the parties to write contracts with open or vague terms with the anticipation that the courts will fill in those gaps or remedy the ambiguities. *Choi* and *Triantis* have shown that incompleteness can be strategic, in the sense that parties choose to include vague terms in their contract and to leave broad interpretative discretion to the courts.[175]

This means that, in an environment where information is costly and sometimes unavailable to the parties at the time of contracting - the so-called "front-end" transaction costs - as well as the parties or the enforcing court at the time of enforcement - the so-called "back-end" transaction costs - the parties are called to decide on a trade-off between the two types of transaction costs. To this end, they may well decide to invest more on the latter, thus leaving broader gap-filling discretion to the courts.[176]

In this context, *Choi* and *Triantis* highlight the importance of completing contracts in the shadow of costly litigation. They observe that the aim of contracts is to align behavioral incentives by invoking legal enforcement. Nevertheless, despite the conventional premise of contract theory that parties write obligations verifiable to the court, the contested conduct is very rarely directly verifiable and enforceable at no cost. On the contrary, the verification of some provisions calls for the use of costly evidence (for example, expert testimony), or even the proof of a subjective situation (as is often the case with "legitimate expectations" in investment arbitration). What is more, the parties may use standards, which are even harder to prove than rules.[177]

In all the above cases of costly verification, the courts (or arbitral tribunals) are called to fill the contractual gaps by injecting content into the disputed standards and determining the relevance and weight of the various evidentiary proxies that the parties present to

[174] See *inter alia* Ménard, C. (2013), *supra* note 22, *Is Public-Private Partnership Obsolete? Assessing the Obstacles and Shortcomings of PPP*, in: (Eds) De Vries & Yehoue, *The Routledge Companion to Public-Private Partnership,* London: Routledge, at 32.

[175] See Choi, A. & Triantis, G., (2007), *Completing Contracts in the Shadow of Costly Verification*, The Journal of Legal Studies, 37 (2): 503. In particular, see also Scott, R. & Triantis, G. (2006), *supra* note 68. Moreover, in line with Hart's contractual theory of the firm, such intended incompleteness seems to be more popular in the case of corporate law. See Choi, A. & Triantis, G. (2010), *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, Yale Law Journal, 119 (5): 848.

[176] As argued in the third chapter, this rationale has well backed also the design of international investment treaties - even unintentionally - as the contracting parties have opted for the inclusion of vague, inherently incomplete standards in such treaties, thus leaving a wide discretion for filling the relevant interpretative gaps to the arbitral tribunals deciding on the ensuing disputes.

[177] See Choi, A. & Triantis, G. *supra* note 111, at 42, 4.

them.[178] This situation of contractual incompleteness due to the use of standards and evidentiary proxies applies *par excellence* in investor-state dispute settlement proceedings. The third chapter elaborates on the potential that interpretative proxies drawn from relational contract theory have to assist tribunals in their efforts to impart meaning to the vague treaty standards - namely, FET - in a way that balances the parties' interests.

The problem of contractual renegotiations is not unique in Economics. Albeit from a different perspective relating specifically to the change of circumstances and hardship, renegotiation has also been the object of analysis in the legal literature. For example, in his book "Arbitration and Renegotiation of International Investment Agreements" *Peter* describes renegotiation as a legal problem by focusing on case law and legal doctrine on the change of state contracts. He notes that, in contrast to international commercial arbitration, where the applicable law is rarely an issue as arbitrators rely, instead, on contract interpretation and trade usages, in the field of state contracts the law applicable to the contract is of crucial importance, especially with regard to the sensitive issue of contractual change.

More specifically, *Peter* observes that the applicable law determines the conditions under which, and the extent to which a party is entitled to change the contract. It also determines the legal consequences of a party's refusal to accept renegotiation and modification, or of the failure of renegotiation, as well as the effects of unilateral (as opposed to renegotiated) contractual change.[179] In line with legal positivism, *Peter's* analysis takes the traditional perspective that only states are the initiators of renegotiation, and consequently the role of the law is exclusively to protect the investor from the ensuing risk of expropriation of its investment by the state.

On the other hand, *Berger* shares *Asante's* perspective that renegotiation and adaptation are integral features of the foreign investment process.[180] He notes that both concession and power purchase agreements are vulnerable to disturbances in their commercial balance (otherwise, the aforementioned principle of "financial equilibrium") agreed to by the parties at their conclusion. He identifies three main causes for such volatility, and the ensuing need to adapt such contracts.

The first one reflects the non-foreseeability of new circumstances. The long duration of concession contracts entailing the commitment of significant capital and the assumption

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[178] See Scott, R. & Triantis, G., *supra* note 63.

[179] Peter, W. (1995), *Arbitration and Renegotiation of International Investment Agreements*, Kluwer Law International, at 130.

[180] Asante, S. (1979), *Stability of Contractual Relations in the Transnational Investment Process*, International & Comparative Law Quarterly, 28 (3): 401.

of considerable risk, makes them susceptible to economic and political influences unforeseeable at the time of their conclusion, which the investor considers to impact negatively the economic equilibrium of the contract. On the other hand, the investor is deemed to depend on the stability of the initial contractual framework to recuperate its investment in the long run. Third, the usual legal argument refers to the risk of obsolescing bargaining, meaning that the state will purportedly attempt to renegotiate the contract once the venture has begun and is thus left to its mercy.[181]

Having set the stage for contractual renegotiations by identifying as their causes the change of circumstances and the state's opportunism, *Berger* then focuses on the legal tools that can protect the investor from such risks and uncertainties. The author's proposals on the remedies of renegotiation take a more balanced approach to the rights of both parties by recognizing that the investor may also need to request renegotiation. To this end, he refers to the utility of the hardship concept in international contract law, as crystallized in particular in the UNIDROIT Principles of International Commercial Contracts.[182]

The principle of hardship aims precisely at maintaining the economic equilibrium of the contract by rendering renegotiation not only legitimate but also obligatory upon the parties, as a legal consequence of the occurrence of hardship. In this sense, hardship proves to be a special form of renegotiation clause, inspired by the same rationale and objective, which is to make contractual obligations more flexible in light of alterations to the contractual equilibrium.[183]

Beneath the hardship defense, another mechanism for softening the rigidity of the principle of *pacta sunt servanda* is an actual renegotiation clause. Nevertheless, even without an explicit renegotiation clause there is arguably an inherent duty to renegotiate in light of changed circumstances, rooted in international contract law and in particular the principle of good faith and the ensuing duty of the parties to cooperate.[184] To corroborate this view, *Berger* refers *inter alia* to the UN Draft Code of Conduct for Transnational Corporations, which contains a provision prescribing renegotiation even in the absence of an explicit clause to this end.[185]

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[181] Berger, K. P. (2003), *Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators*, Retrieved from: https://www.transnational-dispute-management.com/article.asp?key=305, at 1348-1349.

[182] *Doudko* notes that a tendency has begun to emerge treating hardship as a general rule of law. See Doudko, A. (2000), *Hardship in Contract: The Approach of the UNIDROIT Principles and Legal Developments in Russia*, Uniform Law Review, 5 (3): 483.

[183] See Berger, K.P., *supra* note 116, at 1352.

[184] Sornarajah, M. (1994), *The international Law on Foreign Investment*, Cambridge University Press.

[185] See Berger, K.P., *supra* note 116, at 1357.

The provision reads that, in the absence of renegotiation clauses, transnational corporations should respond positively to requests for renegotiation of contracts concluded with governments in situations of duress, clear inequality between the parties, or fundamental change of circumstances that render the contract unfair or oppressive to either of the parties. The provision contains the caveat that, in order to ensure fairness to all parties, renegotiation should be allowed by the applicable law and generally recognized legal practices.[186] *Berger* notes that there are good reasons to assume the existence of such transnational legal principle.[187]

It is already evident from the above that the law under which the renegotiation of a state contract will be evaluated, makes a radical difference for the outcome not only of a contractual but also a treaty dispute ensuing from the renegotiation of an investment contract. What complicates the situation even more is the fact that the law applying in practice to a state contract is not only the law defined in the contract itself but also international law, and in particular the international investment treaty under the umbrella of which the contracts operate. In turn, the treaty, as the applicable law, is an instrument containing open-textured standards subject to the wide interpretative authority of arbitral tribunals, rather than elaborate legal rules stipulating contingencies in an exhaustive way.

As further analyzed above, a contractual approach to investment treaties and investment arbitration is in line with the origins of investor-state dispute settlement not only in public international law, but also commercial arbitration, where contract (or, by analogy, treaty) interpretation and trade usages (such as the UNIDROIT Principles of International Commercial Contracts) have an important role to play. For example, if the law applicable to the contractual renegotiation in dispute is the rigid necessity defense of Article 25 of the Draft Articles on Responsibility of States for Internationally Wrongful Acts with its high bar for accepting necessity, the outcome will be (and has been) different compared to a scenario where arbitrators apply the more flexible hardship standard of the UNIDROIT Principles.

In summary, there are two perspectives prominently missing from the legal writings investigated above and from the legal literature on contractual renegotiations in general. The first is a meaningful dialogue with the Economics (including the political-economy) literature, and more specifically both the theory and the evidence described above, which paint a more multifaceted and accurate picture of renegotiation going far beyond the traditional legal view of obsolescing bargaining, and allowing for substantial policy

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[186] UN-ECOSOC 1979 Transnational Corporations: Codes of Conduct, Formulations by the Chairman, Art. 5.

[187] See Berger, W. *supra* note 116. See also *supra* Peter, W. (1995), at 98.

lessons to be drawn from the efficient[188] governance of state contracts. The second, equally important perspective, is one that explains under which precise legal standards a contractual renegotiation constitutes a breach of the investment treaty within the ambit of which such renegotiation takes place, and concomitantly makes a plausible and consistent argument about the rules and principles that apply (or should apply) to such renegotiation, in order to prevent a breach of the overarching treaty.

iii) Empirical evidence of the relational character of concession contracts

Renegotiation, as a material modification of terms not envisioned by contingencies stated in the contract itself, is, in practice, a perverse phenomenon in concession contracts, resulting in the radical alteration of the concession's financial equilibrium. The fact that neither the original terms of the contract (as would be the case with classical contracts) nor even the adjustment mechanisms provided therein (as would be the case with neoclassical contracts) suffice to serve the long-term needs of the parties, indicates the inherent incompleteness of concession contracts. The extent of the complexity and the inherent incompleteness of the latter is such that renegotiation is left as the only mechanism for the adaptation of the contract to the evolving and often conflicting interests of the parties.

As further described in the empirical findings below, the alarmingly high incidence of the radical modification of the original contracts shows that the parties have been unable (or unwilling) to draft a complete, renegotiation-proof concession contract. Renegotiation is considered herein as a relational element of concession contracts, because it takes place between the parties outside of the framework of the contract's terms. Thus, it signals the importance of the extra-contractual relationship as it has evolved since the signing of the original agreement.

The inevitable need for the renegotiation of complex, long-term contracts has been well evidenced in the economics literature both doctrinally and empirically. As mentioned in the Introduction, a large-scale empirical study of the World Bank has attested to the fact that the renegotiation of concession contracts is a perverse and more complex phenomenon than the theory of obsolescing bargaining seems to suggest. In particular, the study shows that, contrary to the predictions of the obsolescing-bargaining theory, both sides request renegotiations, with the investor often being in the lead of such requests.

[188] Efficiency is herein not defined as a monetary value but as a behavioral-economics value, meaning one that economizes on the behavioral transaction costs of bounded rationality and opportunism.

Both the theory and the data show the correlation between institutional and regulatory failures and the probability of renegotiations. In the context of institutionally weak environments - which after all are the very reason for enacting the mechanism of international investment arbitration - it would be an oxymoron to tolerate such weaknesses at the domestic level while invoking the very same failures to seek protection at the international level. On the contrary, as elaborated upon below, if investment arbitration is to be more balanced, an alignment between the domestic reality and the international rules addressing the investor-state relationship is indispensable.

Delving deeper into the empirical data, the study led by *Guasch* for the World Bank (uncontested to this day), has examined a sample of a thousand contracts in Latin America, and demonstrated that the biggest problem with concessions has been the high incidence of contractual renegotiations shortly after their award. *Guasch* notes that such early renegotiations often undermine the competitive-auction allocation process, consumer welfare, and sector performance. They similarly increase public opposition to private participation in the provision of public services, and compromise the credibility of the reform program.

Another downside of renegotiations is their significant costs, which can lead to large welfare losses. Moreover, if concession contracts are to be renegotiated shortly after their award, as often happens according to the empirical data, the initial bidding or auction turns into a bilateral negotiation between the concessionaire and the government thus undermining the competitive discipline of the bidding process.

What is important to highlight - which has remained, however, unaddressed by the law - is the fact that at this stage the operator has substantial leverage, because the government is often unable to reject renegotiation, and is similarly unwilling to claim failure for fear of political backlash, as well as due to the - often prohibitively - high transaction costs of re-launching the whole process from the beginning. In such a dependency, non-competitive context the investor has the opportunity, through renegotiations, to undermine all the benefits that the government had sought to achieve by means of competitive bidding instead of granting the concession through direct negotiations with a potential operator.

The empirical data below show that the hardest hit has been in the transportation and water and sanitation sectors, with a renegotiation incidence of 55 and 75 percent, respectively. What has been an additional concern is the very fast timing of such renegotiations. Despite signing contracts for twenty or thirty years following elaborate processes of competitive bidding (or auctions) with the ensuing due diligence requirements for bidders, the time between the start of operations and the renegotiation of the contract was found to average only two years.

Table 1 *Incidence of Renegotiation, Total and by Sector*

Incidence of Renegotiation	***Total***	***Total (excluding telecommunications)***	***Electricity***	***Transportation***	***Water and Sanitation***
Percentage of renegotiated contracts	*30*	*41.5*	*9.7*	*54.7*	*74.4*

Source: World Bank

This is not to say that all renegotiation is bad news. On the contrary, it is a normal and expected function in complex and long-term contracts, and can thus be a positive instrument when addressing the inherent incompleteness of concession contracts. Although some renegotiation is desirable and - properly employed - welfare-enhancing, the alarmingly high incidence of renegotiations identified in the aforementioned concessions in Latin America and the Caribbean is highly problematic.

Exceeding reasonable levels, renegotiation raises concerns about the validity of public-private partnerships themselves, and may well indicate excessively opportunistic behavior by new operators and governments alike. The opportunistic or strategic use of renegotiation in order to shift rents from one party to another, and not as a good-faith mechanism for filling gaps in the inherently incomplete concession contracts, can reduce welfare and likewise have negative externalities on the consumers.

Opportunistic renegotiations can induce not only moral-hazard, rent-shifting behavior after the award of the contract, but can also foster adverse selection before the award of the concession. In particular, the empirical analysis shows that two elements play a central role in determining the bids of investors: their assessment of the likelihood of renegotiations, and, concomitantly, how skillful they are in renegotiating.[189] If their assessment on both fronts is positive, investors will bid for the concession.

The findings also show that, once some investors obtained the concession, they requested a renegotiation from the government to secure better terms than those they had achieved as a result of the competitive bidding. Evidently such incentives and behavior risk distorting the positive effects of competition for the concession and leading to the selection not of the most efficient operator, but the one most skilled in renegotiations - which are more common in monopolistic sectors, where cartels are easier to form.

[189] See Guasch, J.L. (2004), *supra* note 32, at 92.

Particularly in very concentrated sectors as utilities are (even internationally), the risk of bidding with the expectation of a later renegotiation to secure higher tariffs and lower investment levels, is even higher.

Anecdotal evidence points to the practice of low-ball bidding, which should raise a red flag. According to the study, examples from Latin America show that many firms have won concession contracts by strategically underbidding or overbidding with the expectation that they would be able to renegotiate afterwards, and governments have often been unable to commit to enforcing those contracts. In this context, companies with higher affiliation and systematic advantages in renegotiating are more likely to win the concession.[190]

Theory backs the relevant data. *Guasch*, *Kartacheva*, and *Quesada* have developed the theoretical framework showing this equilibrium strategy and the occurrence of renegotiation in a non-competitive environment of bilateral negotiations. In this context of bilateral dependency, governments are in a disadvantaged position that grants significant leverage to operators, thus permitting them to improve their positions by capturing more rents compared to their original bids.[191]

It is useful here to dispense with a common misunderstanding. The mainstream view is that the only remedy to opportunistic renegotiations is better regulation. Nevertheless, the relationship between regulation and renegotiation is a double-edged sword. Whereas stronger regulation and the independence of the regulator are indeed factors that can constrain the incentives and possibility of the concessionaire to behave opportunistically, certain features of regulated sectors make them more prone to renegotiation.

In particular, it is the very principle of financial equilibrium - a rather vague standard (similar in this respect to the FET standard) that has been at the core of many arbitral disputes, particularly those that arose from the Argentine crisis - that allows room for investor-initiated renegotiation. The financial equilibrium clause - explicit or implicit to all concession contracts and related legislation - is a valid pillar of any concession, as it entails that investors should earn a fair rate of return on their investments.

The problem with the application of the clause, though, is its disconnection from the investor's request to renegotiate the contract and in particular the potential inefficiency of the investor's operations as the actual reason for such renegotiation. Despite the fact that the principle ought to be subject to various provisos, including its conditioning to cost

[190] See Guasch, J. L., *supra* note 32, at 32-37

[191] Guasch, J.L., Kartacheva, A., & Quesada, L. (2000), *Contract Renegotiations and Concessions in the Latin American and Caribbean Region: An Economic Analysis and Empirical Implications*, Working Paper, World Bank, Washington DC.

efficient operations, the study finds that the costs of providing the service are rarely linked to a benchmark of efficient operations, and when they are, such costs are disputed.[192]

This finding is corroborated by the practice of arbitral tribunals adjudicating treaty disputes arising from the renegotiation of concession contracts. Indeed, rarely has a tribunal opened the "black box" of the operation of a foreign investor, particularly a multinational corporation, and examined the causal relationship between the failure of the concession and the investor's own operations. Even in the rare cases that a tribunal has engaged in such discovery and analysis, as was (to some extent) the case of *Biwater v. Tanzania*, it has done so only at the phase of deciding damages and not by evaluating the investor's conduct when determining whether there was a breach of FET in the first place.

The question surfacing from the above is what the response of the government should be to an opportunistic bid or renegotiation request submitted by an investor. As aforementioned, some renegotiation is desirable as the result of regulation and the inherent incompleteness of concession contracts, crystallized in particular in the financial equilibrium clause. Nevertheless, what should the government do when faced with a seemingly unreasonable bid (one with a very high transfer fee or very low tariff) that does not appear to support the financial equation of the concession's expected operation? Should the firm be held accountable to its bid, or be bailed out?

Guasch argues that the proper answer is (save major external factors) for operators to be held accountable to their bids, and consequently, for governments to reject renegotiation requests, thus assuming the risk of the abandonment of the concession (with the resulting transaction costs of re-letting the contract). Nevertheless, as public choice theory predicts, such abandonment of the concession is an unpopular option for the government due to the high political costs of admitting failure of the (costly) privatization process.[193]

Indeed, the empirical data shows that governments have had a hard time adopting this strategy for fear of political backlash. On the other hand, despite the wide negative publicity that such cases typically attract, the renationalization of private infrastructure projects has been quite uncommon, with only two percent of projects returning in the hands of the state. On the contrary, many governments have conceded rents to operators during opportunistic renegotiations instead of requiring them to observe their initial bids.[194]

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[192] Id., at 36.
[193] See Guasch, J.L, *supra* note 32, at 38.
[194] Id., at 38-39.

A second best response for governments faced with an opportunistic behavior, is to reject aggressive bids. Nevertheless, this option has also proved unpopular, since governments have usually celebrated such bids as a sign of a successful privatization process, or have hesitated to disqualify them for fear of being accused of corruption or favoritism. The study refers to the example of a Latin American water concession, where the government accepted an offer several times higher than the second best, and where the investor requested a renegotiation shortly after it secured the contract, with the consequence that the concession was eventually abandoned.

Not surprisingly the situation has been different in cases where the contracts were granted through direct negotiations with a concessionaire instead of competitive bidding or auctions. The low incidence of renegotiations in those cases - about eight percent of the total sample - is possibly explained by the fact that any rents to be captured were already secured through bilateral, non-competitive negotiations. However, such "sweet deals" are still prone to renegotiation, especially by a new administration contesting the, unfavorable to the state, contract, or following a change in priorities of the undersigned government.

Another driver of renegotiations, often identified as the "cousin" of opportunism, has been information asymmetry. Intrinsic information asymmetries between the investor and the regulator induce incentives for opportunistic renegotiation demands, since, even if the bid is proper, down the road operators can claim cost increases allegedly frustrating the principle of financial equilibrium, and thus request tariff increases to restore the equilibrium of the concession.[195]

Nonetheless, the problem with the transaction cost of bounded rationality is similar to the transaction cost of opportunism; one of the parties is not in a position to verify (at least at a non-prohibitively high cost) whether the information that its counterparty provides, particularly regarding the costs of the concession, is accurate, nor can it observe its operations to evaluate whether they are efficient or not. Consequently, it has to rely on the cooperation and good faith of the concessionaire.

According to anecdotal evidence, among the drivers of opportunistic renegotiations has been the inadequate attention to the political and institutional environment of the host state, regulatory failures, government tolerance of aggressive bidding, and faulty contract design. The first factor refers to the lack of embeddedness of the concessionaires to the political economy of the host state, and in particular their failure to engage with critical stakeholders, such as users opposed to private investment for fear of tariff spikes.

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[195] See Guasch, J.L, *supra* note 32, at 39-40.

As regards aggressive bidding, the study makes reference to the case of the water concession in Buenos Aires awarded to *Azurix*. Despite the winning bidder's offer of the highest transfer fee to the government (significantly higher than the one offered by its competitors), and its extensive investment commitments, problems began shortly after the award of the concession, when the company sought to renegotiate the contract. The government did not concede to renegotiation - one of the few cases where that seems to have happened worldwide. Consequently, the company abandoned the concession and filed for arbitration claiming breach of the Argentina-US BIT.

The *Azurix* case exemplifies the problems arising from aggressive bidding and opportunistic renegotiation requests. More importantly, it shows the complexity of renegotiation not only at the domestic, but also at the international level. Despite the fact that the government decided to uphold the sanctity of the bid and did not yield to the investor's renegotiation request, *Azurix's* conduct was not taken into account by the tribunal in deciding whether there was a breach of the treaty by the host state. Such an artificial disconnection between the contract and the treaty can only create an imbalance in the rights of the disputing parties and a backlash against international investment arbitration.

Another renegotiation evidenced in the study as an example of faulty contract design is the case of *Aguas Argentinas*. In that instance, it was not clear in the concession contract what the consequences of failure to comply with the performance targets would be. Aside from default, the level of underperformance that would trigger payment of the performance bond was unclear. For example, three years following the award of the concession, the regulator began pressuring the concessionaire to return revenues gained due to tariff increases, on the basis that the company had not complied with its contractual obligations, and specifically the agreed-upon investment targets. The investor contested the claim and a compromise was found that included dropping the fee charged to users for future investments.

Under the concession contract, *Aguas Argentinas* assumed full responsibility for the entire water supply and sanitation system, including all commercial and technical risks for its operation. The company also incurred all the financial risks for running the concession. Despite the fact though that the contract was signed for thirty years, shortly after its award the tariff was renegotiated and the regulator granted an increase of 13.5%. This instance shows that, when renegotiation incentives are not properly addressed, the benefits of the original bidding can be annulled, resulting in the selection not of the most efficient investor but the one most skilled in renegotiating.[196]

[196] Id., at 41-54.

On the other hand, while better contract design and implementation are certainly desirable in achieving a fair and sustainable balance between the interests of the investor and the host state, they can be rendered useless if the effect of those contractual provisions is invalidated at the treaty-arbitration phase. An artificial (if not sometimes irrational) disconnection between the contract and the treaty annuls any positive effects that the contractual provisions or an orderly and independent renegotiation process may have achieved at the domestic level.

To be noted that this situation is not limited to concession contracts in public utilities but has also been evidenced in other energy sectors, such as the petroleum sector. For example, in *Occidental vs. Ecuador* the tribunal found that the host state's termination of its contract with the foreign investor was done in bad faith and in contradiction to some "unwritten understanding", as the Claimant argued. As a consequence, the contractual termination was found to constitute a breach of the fair and equitable treatment standard. The question arising in this context is what the parties' incentives to engage in optimal contract design are, if this does not ultimately matter at the phase of treaty arbitration. On the other hand, the reliance of the *Occidental* tribunal on good faith and the wider, "unwritten relationship" of the parties is a sign of the acceptance of relational contract theory in international investment arbitration.[197]

The anecdotal evidence above is confirmed empirically. The study is based on data collected on about one thousand concession contracts in Latin America and the Caribbean between the mid-1980s and 2000. The region was chosen because it had been a pioneer in awarding concessions. The main axes of renegotiation included substantial changes in tariffs, investment plans and levels, exclusivity rights and guarantees, lump-sum payments or annual fees, coverage targets, service standards, and concession periods. Scheduled tariff adjustments stipulated in the contract itself do not count as renegotiation.

Table 3 *Common Outcomes of the Renegotiation Process*

Renegotiation outcome	**Percentage of renegotiated concession contracts with that outcome**
Delays on investment obligation targets	69
Acceleration of investment obligations	18
Tariff increases	62

[197] Except that, if relational contract theory is to deployed to interpret and apply treaty standards, this has to be done - by definition - on the basis of mutuality, that is, by taking into account the conduct of both parties.

Tariff decreases	19
Increase in the number of cost components with automatic pass-through to tariff increases	59
Extension of concession period	38
Reduction of investment obligations	62
Adjustment of the annual fee paid by the concessionaire	
Favorable to the investor	31
Unfavorable to the investor	17
Changes in the asset-capital base	
Favorable to the investor	46
Unfavorable to the investor	22

The empirical findings show that renegotiation was extremely common, occurring in thirty percent of the total number of examined concessions. Excluding the more competitive telecommunications sector (which was privatized rather than partially privatized through concession contracts) the incidence of renegotiations rises to over forty percent, with the water sector in particular suffering from renegotiation in over seventy percent of the cases. In addition to their high incidence, the timing of renegotiations was also alarming, as they occurred in most instances shortly after the award of the contract; on average 2.2 years thereafter, or in the case of water concessions, only 1.6 years after their award.

Table 2 *Average Time of Renegotiation since Award*

All renegotiated concessions	**Transportation sector only**	**Water and Sanitation sector only**
2.2	3.1	1.6

Source: World Bank

The most interesting empirical finding though, which flies in the face of the theory of obsolescing bargaining, refers to the initiator of the renegotiation. In 61 percent of cases it was the investor that requested the renegotiation of the concession contract, while only

26 percent of the cases were initiated by the government. Conditioned on the type of the regulatory regime in place, the concessionaire was almost exclusively the party requesting renegotiation in the case of price-cap regulation, whereas the government was on the driving seat of renegotiations under a rate-of-return regime, but with a much lower incidence.

Table 3 *The Initiator of Renegotiation*

Sector	Both government and investor	Government	Investor
All sectors	13	26	61
Water and sanitation	10	24	66
Transportation	16	27	57

Source: The World Bank

Regarding methodology, the study examined the impact of various explanatory variables on the probability of renegotiation in order to identify the determinants of renegotiation. The choice of the independent (explanatory) variables was based on contract theory and new institutional economics. In particular, the hypotheses tested were the impact on the probability of renegotiation of macroeconomic shocks, enforcement quality, source of project finance, the award criteria (including the extent of competition involved), investment obligations, regulation, risk allocation, electoral cycles, and reputation and the learning curve of the government.[198]

Grouping the variables in three categories – regulation, contract design, and political and behavioral environment – the empirical results show that the existence and type of regulation are indeed significant in preventing opportunistic renegotiations, as long, though, as the information that the concessionaire submits to the regulator is observable and verifiable, and the regulator can thus evaluate the operator's status and claims. On the other hand, the results were not clear regarding the importance of the independence of the regulatory body for limiting renegotiations. *Guasch* observes that this may be due to regulatory failures (including capture), common in the region.

On a similar note, the political environment in the host state has also proved significant in determining the occurrence of renegotiation. Corruption was identified as one of the factors increasing the probability of renegotiation. If an operator believes that their public

[198] See Guasch, J.L., *supra* note 32, at 80-87. The probit analysis included in the study was complemented by a separate paper by Guasch, Laffont, and Straub, which focused on a narrower part of the dataset. See *supra* Guasch, J.L., Laffont, J.J., Straub, S. (2003), Renegotiation of Concession Contracts in Latin America.

counterpart is subject to influence, such belief will also enhance its conviction that renegotiation and the capture of further rents are possible.[199] A recent trend in international arbitration has started to take into account corruption at the domestic level in order to disqualify an investor either at the jurisdiction or the merits phase of the dispute.

As mentioned in the Introduction, tribunals that have shown such sensitivity to corruption have been those in *World Duty Free v. Kenya* and *Metal Tech v. Uzbekistan*.[200] In the first case the arbitrators, applying both domestic law and international public policy, declared the contract between the foreign investor and the host state null and void, and concluded that it was not possible to uphold claims for ICSID tribunals premised on contracts granted due to corruption. On the other hand, in the *Metal Tech* case the tribunal, after assessing all the circumstantial evidence (thus adopting a more flexible, relational approach to the factors relevant for deciding the case) declared that there were enough indicators to establish corruption, and as a result declined jurisdiction over the case due to its illegality.

A factor that the study touches upon, but which has remained unexplored so far, is the impact of arbitration on the probability of renegotiation, and in particular of strategic renegotiation. What the empirical findings show is that, because arbitration rules help settle disputes, thus making renegotiation less costly, the existence of formal arbitration rules increases the probability of renegotiation.[201]

Given the indirect relationship between treaty arbitration and the renegotiation of the underlying contracts (indirectness often exacerbated by the artificial separation between the contract and the treaty), this thesis follows a qualitative methodology (based on case-law and doctrinal analysis) to argue in favor of an arbitral system controlling for rent-shifting contractual renegotiations. It is precisely in weak institutional and regulatory environments - which international arbitration was designed to primarily target - that a more pragmatic approach to the resolution of investor-state disputes is needed.

Pragmatism and equity in this context mean that it is an oxymoron to establish an international system to tackle the regulatory and institutional weaknesses of the host state, but at the same time turn a blind eye to those very same weaknesses, when they may be used domestically for rent-shifting purposes. Indeed, institutional and regulatory weaknesses do exist in many host states and this is the very reason for which an independent international dispute resolution system has been established. As a result,

[199] See Guasch, J.L., *supra* note 32, at 91-93. See also *supra* Guasch, J.L. & Straub, S. (2009), Corruption and concession renegotiations. Evidence from the water and transport sectors in Latin America.
[200] See *supra* p. 27
[201] See Guasch, J.L., *supra* note 32, at 76.

arbitral tribunals are expected to account for those weaknesses in a mutual way (using the proxies of relational contract theory), and not treat the host state as if it were the prototype of an ideal state with the perfect regulatory and economic environment.

In addition to the empirical reality of renegotiations, "embeddedness" is another factor confirming the relational nature of concession contracts - at least those characterized by long-term success. In an empirical study originating in political economy, Professor *Post* paints a more complex picture of the governance of concession contracts and their renegotiation. Focusing on the water and sanitation sector in Argentina, the author shows that the concessions that stood chances of success were those based on "relational contracts". She defines "relational" by reference to those contracts involving direct negotiation with the host government in the face of unforeseen circumstances.

"Embeddedness" in this context means a wider network of relationships between the host state and the concessionaire. *Post's* argument is that investors with multiple, diversified holdings in a host state with volatile political and economic environment are in a better position to maintain bargaining relationships with the state in the long run than investors with more scattered portfolios. Running against standard political-economy theories arguing for the advantages that multinational corporations enjoy in sectors with high entry barriers and fixed assets, the author shows quite the reverse: investors diversified at the local level can navigate better any economic and political turbulences that arise during the lifecycle of the concession contract.

In particular, the author tests the theory predicting that domestic investors with diverse shareholdings in the jurisdiction of the host state are in a better position to maintain bargaining relationships with the host state during periods of economic or political turbulence, when state leverage increases. She finds that such investors are more adept at continuing to bargain and invest in the host state during such periods, compared to international investors that typically have more scattered international portfolios. This is because investors with relational contracts have more patience and leverage and can engage in a wider range of trade-offs with the host state.

Furthermore, *Post* finds that among the contracts of investors without diverse holdings in the host state, it was in particular those held by international investors – which in the Argentine cases (that were the focus of her research) enjoyed coverage by bilateral investment treaties – that were the most likely to be terminated early. As opposed to domestic investors with diversified portfolios in the host state, the common strategy of foreign investors once the crisis in Argentina erupted, was to pull out of their investments and legalize the situation by resorting to the protective regime of BITs. In particular, it was more unlikely for foreign investors that had incurred high levels of debt – often overseas – to strike a deal with the government, due to the difficulty of selling their

indebted investment, and it was especially those investors that would take recourse to international arbitration.[202]

Post thus relies on behavioral economics to show that investors maintaining multiple contractual relations with the host state have stronger incentives to be patient in "hurdle" periods (instead of withdrawing their investment and entering in a dispute with the state). They also have better leverage in negotiations with the state, since they are able to negotiate concessions in another sector of the local economy, which they have invested in, as a *quid pro quo* for their patience with the turbulent investment.

Local diversification and the consequent building of networks in the host state, as well as perseverance in times of turbulence, do not usually characterize the business strategies of multinational corporations, which prefer to hold portfolios in different jurisdictions (as a risk management strategy) and are often subject to pressures for short-term profits by their parent companies.[203] Moreover, multinational firms are typically inclined to exceed debt-equity ratio standards and finance up-front investments via long-term loans from multilateral institutions and private banks.

Moreover, using *Macneil's* and *Williamson's* three-way classification of contracts, *Post* notes that relational contracts assume incompleteness and also provide a general format for renegotiation between the parties. In this context of incompleteness, the original contract is not taken any more as the point of reference, but is subject to the overall relationship resulting from all the interactions of the parties since the signing of their initial agreement. Then she moves on to observing that, especially in weak institutional environments where the courts and regulators are not impartial arbiters, it makes the most sense to categorize infrastructure and utilities contracts as "relational".[204]

To this end, the author makes reference to the World Bank studies investigated above proving the remarkable frequency of renegotiations and thus showing that the common practice of parties to concession contracts is to renegotiate such contracts, as new information is revealed or circumstances change. In other words, the government and the

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[202] Post, A. (2008), Liquid Assets and Fluid Contracts: Explaining the Uneven Effects of Water and Sanitation Privatization, Harvard Dataverse, V3, Retrieved from: https://dataverse.harvard.edu/dataset.xhtml?persistentId=hdl:1902.1/12294, at 37, 44, 291-292

[203] See Post, A. *supra* note 103, at 15-16, 29. See also Dobbs, R., Koller, T. & Ramaswamy, S. (2015), *The Future and How to Survive It,* Harvard Business Review, Retrieved from: https://hbr.org/2015/10/the-future-and-how-to-survive-it, at 48: In a McKinsey survey […] 63% of respondents said the pressure to demonstrate short-term financial performance has actually increased since the 2008 crisis […]

[204] Post, A. *supra* note 103. The same argument, though, about the relational character of infrastructure contracts, is also made for concession contracts in developed markets, such as the United States. See Shugart, C. (1998), *Regulation-by-Contract and Municipal Services: The Problem of Contractual Incompleteness*, Retrieved from: http://sunzi.lib.hku.hk/ER/detail/hkul/4118397

investor negotiate at regular intervals over the extent to which they will fulfill their contractual obligations or, instead, revise their original agreement.

In a nutshell, *Post* goes a step further in identifying the relational elements characterizing concession contracts. In addition to pointing to their frequent renegotiations as proof of their relational nature, she takes a broader view of the parties' relationship. According to her view, "relational" means also "embedded" into the environment of the host state.

Despite their different focus, both empirical studies share a common finding: concession contracts are by definition non-rigid, evolving contracts, subject to renegotiation and modification, both in the event of hardship and during normal times. Their fluid and relational nature requires a robust and good-faith collaborative relationship between the parties, who are thus expected to be able to continuously strike an equilibrium between their (often conflicting) interests.

What is even more important, is the studies' complementarity, despite their different origins. *Guasch's* empirical data show that concession contracts are relational, in the sense that they are renegotiated during normal times (and even very early on) despite including rigid terms expected to last for decades (at least according to the predictions of classical and neoclassical contract theory). On the other hand, *Post's* research shows that, when hardship occurs, those same investors that (according to *Guasch's* study) had renegotiated the contract during normal times, decide to abandon their investment and legalize their relationship with the host state by resorting to international arbitration to claim damages.[205]

Adopting an interdisciplinary, pragmatic and problem-solving approach, the present thesis takes stock of the findings of both studies in attempting to theorize the empirical data collected therein. The goal is to make a first step towards conceptualizing a theory for the renegotiation of complex, long-term investment contracts that operate in the shadow of international investment treaties and their investor-state dispute resolution mechanism. In particular, the argument herein is that, it is precisely in the context of weak institutional environments that international arbitration has a determinative (yet so far unexplored and underestimated) role to play in forcing the alignment of the incentives of the contractual (and later disputing) parties, and controlling for the transaction costs of bounded rationality and opportunism in the governance of their contractual relationship.

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[205] This option is of course open only to international investors. On the contrary, domestic investors are usually better off holding on to their relational contract and trying to negotiate a solution with the host state instead of abandoning their investment and legalizing the situation.

iv) Concluding Remarks: The need for an international-law response to renegotiation

This chapter demonstrated the relational character of concession contracts, following *Macneil's* categorization of contracts into classical, neoclassical, and relational, and the implications of such differentiation for their governance and renegotiation. The argument underlying the current analysis of concession contracts is that their nature and governance are closely related to the overarching investment treaties, thus having a direct impact on the adjudication of the standards included therein, namely the FET standard. An underlying relational contract can serve as a legal justification for the application of relational-contract-theory norms in interpreting FET, when the issue of a contractual renegotiation is at stake.

In summary, there are several elements pointing to the relational character of concession contracts. First, the very definition of a public-private partnership, as a public-management mode for the implementation of concession contracts, illustrates the cooperative nature of the relationship of the parties, as partners in a joint venture. In the context of such a long-term, complex partnership, concession contracts incorporate the tension between the need for the stability and legal certainty of their terms and the necessity to adapt to the changing circumstances inevitably arising during the long lasting partnership.

The necessity for adaptability and a workable relationship between the parties is evident also empirically, as the frequent renegotiations of concession contracts demonstrate. Likewise, the embeddedness of those concession contracts that were successful in the long run in the environment of the host state shows that, apart from laying down the legal terms of their contract, the investor and the host state also develop a wider relationship essential for the governance of the concession.

As aforementioned, not all renegotiation is bad news. On the contrary, it is a normal and expected function in complex and long-term contracts, and can thus be a positive instrument when addressing the inherent incompleteness of concession contracts. The fact that renegotiation is inevitable does not mean, though, that it should also be left unregulated. The tension between the adaptability and the stability of the economic equilibrium of the concession contract always exists, and renegotiation shall be conducted in a way that facilitates adaptation while fostering legal certainty. Whereas renegotiation is a necessary mechanism to address the inherent incompleteness of concession contracts and produce efficiency gains, it shall be transparent and in good faith. Opportunistic renegotiations shall be filtered out and corruption shall be prevented through appropriate renegotiation rules.

Regulated renegotiation is often recognized as both a necessity and a priority for investment contracts in general. *Sornarajah* rejects the static (or classical, under *Macneil's* aforementioned classification) model of international investment contracts in favor of the dynamic (or relational) model. He remarks that there is little room for the static principle of "pacta sunt servanda" (as expressed, for example, through stabilization clauses) in the case of state contracts, which are by definition unstable, being subject to political and socio-economic changes.[206]

Sornarajah also rebuts the assumption of the static model that the host state must bear the risks ensuing from changed circumstances, arguing instead that risk allocation requires that foreign investors expecting to make higher profits shall also bear equally increased risks, including the risks of the potential miscalculation of their profits. He similarly argues that, as in the domestic market a business person bears the risk of business failure, the same should be the case for a foreign investor.

In a similar vein, *Sornarajah* proposes the formal recognition of the inherently incomplete and volatile nature of investment contracts and the ensuing incorporation of dynamic clauses into the contract. In his proposed dynamic model, renegotiation clauses hold a prominent role in the adaptation of investment contracts to the changing circumstances. Especially in complex and strategic domains, like infrastructure, or similarly, in the volatile sector of natural resources, such as the oil industry, renegotiation is an inevitable reality.

For example, the arbitral tribunal in the *Aminoil* award refused to accept a stabilization clause in the concession contract, on the basis that the contractual equilibrium was upset by the rapid transformation of the oil industry leading to windfall profits for the investor. It notably held that there could be a change in the nature of the contract itself "brought about by time and the acquiescence or conduct of the parties".[207] The reference to the (extra-contractual) "conduct" of the parties points precisely to the argument made herein, i.e. that in complex, concession contracts arbitrators focus not only on the "four corners" of the original agreement and their ordinary meaning, but evaluate the entire relationship and conduct of the parties as it has evolved.[208]

As opposed to stabilization clauses, *Sornarajah* proposes the incorporation of renegotiation and hardship clauses in the investment contract as mechanisms to avoid disputes between the parties and enable the adaptation of their long-term relationship to

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[206] Sornarajah, M. (1988), *Supremacy of the Renegotiation Clause in International Contracts*, Journal of International Arbitration, Journal of International Arbitration, 5: 97, at 101.
[207] The Government of the State of Kuwait v. The American Independent Oil Company, *Ad hoc* Arbitral Tribunal, Award, 24 March 1982, 21 ILM 976, para 101.
[208] Sornarajah, M. (1988), *supra* note 207, Supremacy of the Renegotiation Clause in International Contracts, at 101-102, 106.

changed circumstances and the restoration of the contractual equilibrium. He further recommends that, given the inherent incompleteness and instability of this type of contracts, a renegotiation clause shall be inferred, even when not explicitly provided for in the contract, and that this norm is being developed in international practice. He cites as example (in addition to the *Aminoil* award) the dispute of *S.P.P. v. Egypt*, where the tribunal accepted the defense of *force majeure* due to the change of the political circumstances which the contract operated in.[209]

In a nutshell, the argument for the adaptability of concession contracts, as complex, long-term contracts, to the changing circumstances or the revelation of new information is valid both under law and economics. The question thus arising in this context is how to balance this adaptability (or, in legal terms, the doctrine of *clausula rebus sic stantibus*) with the also essential need for the stability and the predictability of the contractual relationship (or the doctrine of *pacta sunt servanda*).

The complexity of such trade-off is compounded by the protection of the investors' contractual rights by investment treaties, and the resulting option for foreign investors to terminate[210] their contract during times of turbulence and seek compensation before international arbitral tribunals[211] often arguing for the breach of a treaty standard (particularly FET).

In this context, the following chapters aim at re-establishing the foundations of investor-state arbitration on grounds accounting for the relational character of concession contracts. This can be achieved through an integrationist approach to the contract and the treaty (analyzed in the next chapter), combined with an interpretation of FET based on the proxies of relational contract theory (elaborated upon in the third chapter). The doctrinal analysis complements the examination of the relevant case law on the adjudication of treaty disputes resulting from the renegotiation of concession contracts, and the identification of elements of relational interpretation therein.

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[209] Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt, ICSID Case No. ARB/84/3, Award, 20 May 1992, paras 190-191.

[210] Besides, given the fact that their investment is heavily indebted, it would be more difficult to sell it to a local buyer instead of terminating it.

[211] See Post, A., *supra* note 103, at 25.

1. The Impact of International Investment Treaties on Investment Contracts

This chapter examines the connecting links between the treaty and the underlying concession contract by identifying those legal rules and principles relating the two instruments. The connecting links identified below - "umbrella clauses", "legitimate expectations", and the UNIDROIT Principles of International Commercial Contracts – can serve as "entry points" for the application of relational contract principles to the interpretation of the open-textured treaty standards. The argument underpinning the application of contract theory to treaty interpretation is that it is not only investment treaties that have an impact on the underlying contracts, but also these contracts have an impact on the interpretation of the overarching treaties.

A plethora of resources has been devoted to exploring the impact that international investment treaties have on the investment contracts under their coverage, and in particular the internationalization of these contracts. *Voss* has analyzed quite succinctly the legal consequences that the advent of investment treaties has had on the underlying contracts by focusing on the evolution of investment protection and investor-state arbitration, which now "represent a new dimension of the respect for individual rights by States in the global economy." [212] He observes that the "internationalization" of investor-state contracts alone has been unsuccessful, and explains the conflicting approaches to the interrelation between treaty and contract law.

He finds in this regard that there have been two main schools: one has tried to keep the contract and the treaty in clinical isolation from each other, while the opposite school has supported a "flexible and open-textured reading of BITs as encompassing a broad range of rights and obligations", including contractual issues. He stresses that finding a new and consistent balance between these two approaches can be decisive for the future of investment arbitration. [213]

[212] See *supra* Voss, J. (2010), *The Impact of Investment Treaties on Contracts between Host States and Foreign Investors*, at 7.
[213] Id., at 11. See also Lorz, R.A (2012), *The Impact of Investment Treaties on Contracts between Host States and Foreign Investors by Jan Ole Voss - Book review*, Retrieved from: https://www.transnational-dispute-management.com/article.asp?key=1856, at 2.

Voss observes that there are several ways to bring about the internationalization of state contracts, meaning their detachment from the national legal order that would normally provide for the forum and applicable law under which a contractual dispute would be settled. He considers "direct internationalization", whereby *lex contractus* is declared to be an autonomous legal order, to be ineffective in terms of the enforceability of an ensuing award, as it places the award in a legal vacuum. Equally unworkable he deems the "indirect internationalization" method, which rests on the application of private international law and the principle of party autonomy. He identifies similar enforcement difficulties in this context, unless the potential award is attached to a national or international legal system making its enforcement possible.

As a result, the author turns to examining whether the legal effects of the internationalization of contracts have changed under the regime of investment treaties. To this end, he argues that a meaningful distinction between "simple" breaches of contract and those crossing the threshold of a treaty breach can only be drawn along the lines of the classical differentiation between acts *jure gestionis* and *jure imperii*. *Voss* adds in this respect that, if a state acts in its commercial role, no treaty violation occurs, whereas if it breaches a contract exercising governmental authority, a breach of the treaty is possible.[214]

Orrego Vicuña has also pointed to the internationalization of investment contracts by means of the overarching investment treaties. He goes as far in finding a strong connection between the two instruments as to state that "today it is necessary to explain that contracts are like treaties, only between individuals and the state". The author considers this inseparable connection to be part of the process of the globalization of the law, and adds that what used to be a mere comparison between international law and a separate domestic legal framework – treaties and contracts – has now become part of a "single" legal structure encompassing both contracts and treaties.[215]

Recognizing the blurred distinction between public and private, *Orrego Vicuña* aims to explain the process of the transformation of the law through the internationalization of the contracts by means of their interaction with treaties. He also emphasizes the influence of the *lex mercatoria* in enlarging the governing legal framework,[216] and the meaningful role of international arbitration in consolidating the legal trends emerging from this state

[214] See *supra* Voss, J., at 25-26, 34 et seq., 196.
[215] Orrego Vicuña, F. (2004), *Of Contracts and Treaties in the Global Market,* Retrieved from: http://www.mpil.de/files/pdf1/mpunyb_orrego_8.pdf, at 341.
[216] See also *infra* section on the relevance of the UNIDROIT Principles of International Commercial Contracts as an emerging part of the applicable legal framework in treaty disputes involving investment contracts, especially in case of their renegotiation due to hardship.

of flux.[217] He notes in this regard that internationalization is even more prominent in the field of state contracts compared to purely private contracts, and in particular concession contracts have come to such close contact with international law as to resemble the effects of treaties.[218]

The ever closer connection between state (previously, purely administrative) contracts and treaties has led to a great division among scholars regarding the question whether the breach of contractual rights can amount to a breach of the state's international obligations, thus engaging its international responsibility. Some argue that concession contracts fall always within the administrative ambit of state sovereignty, whereas others contend that those contracts are no longer merely domestic contracts, but on the contrary, are subject to international law. Others have proposed intermediate approaches based on transnational law.[219]

Despite the inseparable connection between the two instruments, contracts are not assimilated to treaties. As Professor *Weil* has noted, "*l'internationalisation ne signifie ni que le contrat devienne l'équivalent d'un traité international ni que les règles du droit international interétatique soient transposables purement et simplement au domaine des contrats. Le contrat n'est pas assimilable à un traité, il est simplement un acte international d'un type nouveau. Le droit international qui lui est applicable ne sera pas exactement le même que celui qui régit les rapports entre Etats, et notamment les traites internationaux.*" [220]

It ensues from the above that the internationalized concession contracts are neither mere administrative contracts anymore nor akin to the treaties under the umbrella of which they operate. On the other hand, it is clear that the advent of treaties has transformed the nature of the underlying contracts by elevating them (albeit not completely) to the level of international law, in a way that gives them the status of international instruments of a novel, hybrid type. In the context of such legal regime in the making – without a

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[217] The decision-making authority of arbitral tribunals is also emphasized by the common-law approach. See *infra* part on the different interpretative approaches to investment treaties.

[218] See Orrego Vicuña, F., *supra* note 217, at 345. Similarly, the blurred distinction between public and private has also been recognized in case law, including the cases dealing specifically with the renegotiation of concession contracts. An illustrative example was *PSEG v. Turkey*, where there was a continuous "battle of the forms" between the public and the private-law status of the concession contract, with its conversion to a contract governed by private law being one of the disputed issues before the arbitral tribunal. See PSEG v. Turkey, ICSID Case No. ARB/02/5, Award, 19 January 2007.

[219] Lalive, J. (1983), *Contrats entre Etats et personnes privées,* Retrieved from : http://rbdi.bruylant.be/public/modele/rbdi/content/files/RBDI%201975/RBDI%201975-2/Etudes/RBDI%201975.2%20-%20pp.%20562%20à%20594%20-%20F.A.%20Mann,%20I.%20Seidl-Hohenveldern,%20P.%20Lalive,%20G.%20van%20Hecke.pdf & Grigera Naón, H. (1989), *El Estado y el Arbitraje Internacional con Particulares*, Revista Jurídica de Buenos Aires, II-III.

[220] Weil, P. (1969) *Problèmes relatifs aux contrats passés entre un Etat et un particulier*, Collected Courses of the Hague Academy of International Law, 128: 95, at 188.

centralized power for its formation – arbitral tribunals have played a decisive role in clarifying the rules and establishing the norms that regulate such hybrid contracts, especially regarding their interaction with the overarching treaties.

To this end, a criterion used to determine the law applicable to such hybrid, half-international, half-administrative, investment contracts has been the distinction between acts *jure imperii* and *jure gestionis*. However, this criterion has not always been used consistently in treaty-disputes ensuing from this type of contracts, as analyzed below. The lack of consistency in differentiating between purely commercial disputes and those entailing the international responsibility of the host state shows the practical difficulty of distinguishing both between the two instruments and between different aspects (public and private) of the very same instrument.

As analyzed in the previous chapter, concession contracts have a dual (both private-commercial and public-regulatory) nature, and each of these two sides produces different legal consequences. The complexity of differentiating between these two sides of the same legal instrument is compounded by the interaction of the contract with the treaty, and the lack of clear criteria to discern those contractual acts violating the treaty from those that are purely contractual (even when they are administrative, thus falling under the jurisdiction of administrative tribunals) or commercial acts, thus operating outside of the treaty's ambit.

2. The relationship between contract claims and treaty claims

a) The blurred distinction and the Vivendi I case

There is a dearth of literature addressing the question on the relationship between contract claims and treaty claims, and their alleged distinction. The usual approach taken in evaluating the relationship between the two instruments is both a top-down and a jurisdictional one. In other words, it focuses on the one-sided (as classical contract theory would advocate for) impact of treaties on contracts and not the mutual relation (and connection) of the two.

Departing from the habitual focus on the (jurisdictional) distinction between the contract and the treaty, this section explores those legal tools and connecting factors that prove the mutual relationship between the contract and the treaty, and in particular the legal relevance of contractual renegotiations (and the process for their implementation) for

interpreting the vague treaty standards, namely FET, and determining whether the contractual renegotiation constitutes a breach of the treaty or not.

Before elaborating, though, on the interconnection between the contract and the treaty - at least for the treaty disputes ensuing from the renegotiation of concession contracts - it is useful to refer to the relevant literature on the relationship between contract and treaty claims, as well as the landmark (albeit often contradictory) cases in this regard, namely the *SGS* disputes[221] and the decision of the Annulment Committee[222] in *Vivendi I*.[223]

As *Van Harten* observes, investment treaty arbitration is deeply intertwined with contract-based adjudication. He cites in this regard a study finding that approximately two-thirds of investment treaty cases appear to have involved a contract (presumably with its own dispute settlement clause) related to the dispute brought under the treaty. The author notes that in light of this overlap the question that has emerged is whether the treaty tribunal should stay or delay its own proceedings in deference to a contractually-agreed forum. He argues that principles of party autonomy and sanctity of the contract[224] would instruct arbitrators to allow other fora to resolve the dispute, and limit themselves to providing a check against sovereign interference with the contract-based forum,[225] but tribunals have nevertheless denied to show such restraint and deference to a contractual forum.[226]

A (failed) attempt to show deference to the domestic, contractual forum was the award in *Vivendi I*, which involved a treaty claim arising from the renegotiation of a concession contract between Argentina and French investors. The tribunal declined to hear a treaty-based claim on the grounds that it was closely connected to a concession contract including its own exclusive jurisdiction clause. It consequently held that given the nature of the dispute between the claimants and the Province, it was not possible to determine which actions of the Province had been taken in exercise of its sovereign authority and which in the exercise of its rights as a party to the concession contract, considering in

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[221] *SGS Société Générale de Surveillance S.A. v. Pakistan*, Decision on Jurisdiction, ICSID Case No. ARB/01/13, 6 August 2003, paras 166-174 & *SGS Société Générale de Surveillance S.A. v. Philippines*, Decision on Jurisdiction, ICSID Case No. ARB/02/6, 29 January 2004.

[222] *Compañía de Aguas del Aconquija S.A. and Vivendi Universal (formerly Compagnie Générale des Eaux). v. Argentine Republic*, Decision on Annulment, ICSID Case No. ARB/97/3, 3 July 2002.

[223] *Compañía de Aguas del Aconquija S.A. and Compagnie Générale des Eaux v. Argentine Republic*, Award, ICSID Case No. ARB/97/3, 21 November 2000.

[224] Which is evidently put to test in the case of the frequent renegotiations of concession contracts.

[225] Along these lines is the proposal for assigning the process for the renegotiation of a concession contract to independent mediation, as analyzed below.

[226] Van Harten, G. (2014), *The Boom in Parallel Claims in Investment Treaty Arbitration*, Investment Treaty News Quarterly, 5: 7.

particular that much of the evidence presented to the tribunal referred to the performance of the contract.[227]

The tribunal thus concluded that the contract and treaty matters were "so crucially interconnected" that it was impossible to determine which actions of the Province were taken in the exercise of its sovereign authority from an independent view of the alleged violations of the BIT. As a result, it found that the claimants should have challenged the issues arising from the renegotiation of the contract by the Province before its administrative courts first.[228] On the contrary, any claim under the BIT would arise only in the event that an investor was denied access to those courts, or was treated unfairly during the court proceedings (denial of procedural justice), or the ensuing judgments were substantively unfair (denial of substantive justice), or was otherwise denied the rights guaranteed to her under the treaty.[229]

This finding on the merits, about the "impossible distinction between contract and treaty" claims, comes as no surprise for disputes arising specifically from concession contracts. As analyzed above, these are, to a large extent, regulatory contracts involving by definition the exercise of sovereign authority, not only by the state but also the concessionaire, which is assigned with the management of a public utility, thus acting in this capacity as an agent of the state.

The tribunal in *Joy Mining v. Egypt* alluded to the possibly different relationship between the contract and the treaty in different (types of) disputes by ruling that "the connection between the Contract and the Treaty is the missing link" that prevented - in that particular case - the transformation of all contract claims into treaty disputes, and that this finding might be perfectly different in other disputes where that link is found to exist.[230]

"Matching different transactions with different governance structures in a discriminating way" [231] means that a treaty dispute involving an investment contract, for example, in the hotel sector (like the case of *Wena Hotels vs. Egypt*) [232] is in no way the same (and consequently does not present the same challenges for distinguishing between contract and treaty claims) as a treaty dispute ensuing from the renegotiation of a hybrid (both

[227] Which was also the case with the other disputes that arose from the Argentine crisis and the renegotiation of concession contracts.
[228] See *Vivendi I* award, *supra* note 224, p. 3. See also Muchlinski, P., Ortino, F. & Schreuer, C. (2008), *The Oxford Handbook of International Investment Law*, Oxford University Press, at 965.
[229] See *Vivendi I* award, *supra* note 224, para 78.
[230] *Joy Mining Machinery Ltd. v. Egypt*, Award on Jurisdiction, ICSID Case No. ARB/03/11, 6 August 2004, para 63.
[231] See *supra* Williamson, O. (1979), Transaction-Cost Economics: The Governance of Contractual Relations, Journal of Law and Economics, 22 (2): 233, at 234.
[232] *Wena Hotels Ltd. v. Arab Republic of Egypt*, Decision on Application for Annulment, ICSID Case No. ARB/98/4, 5 February 2002.

regulatory and commercial), concession contract, which incorporates in itself the exercise of public power (more importantly) not only by the state but also by the investor in charge of offering a public good, like water or electricity.

In this sense, a "unified theory of fair and equitable treatment" [233] should not be possible, at least in the sense of an expansive interpretation of the standard incorporating a uniform doctrine of "legitimate expectations". As analyzed below, the content of "legitimate expectations" has to vary according to the particular characteristics of the underlying contractual relationship of the parties. This means that in the context of treaty disputes arising from the renegotiation of concession contacts, the doctrine has to be interpreted using the proxies of relational contract theory, namely "mutuality" and "dynamism".

Going back to *Vivendi I*, the award of the arbitral tribunal was finally overturned by the Annulment Committee, which distinguished between claims based on the BIT and those based on the concession contract. The Committee held that the forum selection clause in the concession contract did not affect the claimant's right to resort to international arbitration to pursue breaches of the BIT.[234]

Schreuer highlights the following passage of the award as decisive for the distinction between contract and treaty claims: "Finally the Tribunal holds that Article 16.4 of the Concession Contract does not divest this Tribunal of jurisdiction to hear this case because that provision did not and could not constitute a waiver by CGE of its rights under Article 8 of the BIT to file the pending claims against the Argentine Republic… In this case the claims filed by CGE against the Respondent are based on the violation by the Argentine Republic of the BIT through acts or omissions of that government and acts of the Tucumán authorities that Claimants assert should be attributed to the central government." [235]

The Committee concluded that "as formulated, these claims against the Argentine Republic are not subject to the jurisdiction of the contentious administrative tribunals of Tucuman, if only because, *ex hypothesi*, those claims are not based on the Concession Contract but allege a cause of action under the BIT. Thus, Article 16.4 of the Concession Contract cannot be deemed to prevent the investor from proceeding under the ICSID

[233] Vandevelde, K. (2010), *A unified theory of fair and equitable treatment*, New York University Journal of International Law and Politics, 43 (1): 43.
[234] See the *Vivendi* Annulment Award, *supra* note 223, particularly paras 76, 95.
[235] Schreuer, C. (2005), *Investment Treaty Arbitration and Jurisdiction over Contract Claims – the Vivendi I Case Considered*, in: Weiler, T. (Ed.) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law,* Cameron May Ltd, at 283.

Convention against the Argentine Republic on a claim charging the Argentine Republic with a violation of the Argentine-French BIT." [236]

The reference to the "formulation" of the claims ("as formulated") seems to be rather formalistic (in other words, the equivalent of a classical-contract-law approach), as it does not clarify which substantive criterion the tribunal used to arrive at a clear distinction between the matters falling under the contract and those matters potentially constituting a breach of the treaty, thus opening the road to potential forum shopping. Equally unclear was the Committee's reference to the "essential basis" of the claim in stating that "in a case where the essential basis of a claim brought before an international tribunal is a breach of contract, the tribunal will give effect to any valid choice of forum clause in the contract."

The Committee cited in this regard the *Woodruff* case, where a contractual clause stipulated that "doubts and controversies which at any time might occur in virtue of the present agreement shall be decided by the common laws and ordinary tribunals of Venezuela." [237] Nevertheless, the usefulness of deciding such controversy, for example, a renegotiation, under the domestic law of the host state, is doubtful, if the legal effects of the very same renegotiation (produced under the local procedure) are to be disregarded at the phase of a treaty dispute arising from the same subject matter.

On the other hand, one of the findings of the Committee is more amenable to the argument made herein. This is the Committee's statement that "it is evident that a particular investment dispute may at the same time involve issues of the interpretation and application of the BIT's standards and questions of contract." [238] Despite the fact that the Committee ultimately ruled that breaches of contract and breaches of treaty are related to independent standards, it also recognized the connection between the two instruments by holding that the tribunal has to take into account the terms of the contract in determining whether there has been a breach of a treaty standard.[239]

This thesis endorses such quasi-integrationist approach with two important caveats: first, such "taking into account" of the contract in interpreting a treaty standard should not be considered a merely factual matter, but has to be part of the "applicable law". This means in particular that the renegotiation of the contract is a core legal matter producing distinct legal consequences that have to be "taken into account" while interpreting and applying a treaty standard, namely FET.

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[236] See *Vivendi* Annulment Award, *supra* note 223, para 37.
[237] Id., paras 98-99. The *Vivendi* case is not the first one that dealt with the conflict of jurisdictional clauses in a treaty and the underlying contract. The issue had also been addressed in *LANCO v. Argentina*. See *LANCO v. Argentina*, Decision on Jurisdiction, ICSID Case No. ARB/97/6, 8 December 1998.
[238] See para 60 of the Annulment Decision in *Vivendi I*.
[239] Id., paras 95-96, 105.

Second, the “terms of the contract” have to be perceived widely, according to the tenets of relational contract theory applying to concession contracts. In other words, such terms are not confined to the “four corners” of the agreement (as is the case for simple, classical contracts) but encompass the overall relationship of the parties, as it has evolved since its very beginning – including any other renegotiations that may have taken place before the last one that gave rise to the treaty dispute.[240]

In other words, this thesis takes a different perspective from the one emphasizing the impact that international treaties have on the underlying investment contracts, and advocates that also those contracts – at least, the relational, concession contracts – have an impact on the overarching treaties, and in particular the interpretation and application of the vague standards included therein. This means that a tribunal has to look at the concession contract and its overall governance (including all its renegotiations) “as part of the applicable law”, in order to evaluate, “using the relational proxies of mutuality and dynamism”, whether a contractual renegotiation constituted a breach of the overarching treaty.

This would not entail an evaluation by the tribunal of all the matters falling under the contract (which would be an inadmissible extension of its jurisdiction, and thus an excess of its powers). What it means, though, is that “as far as the matter of the contractual renegotiation is in dispute, in order to evaluate whether such renegotiation constituted a breach of treaty”, a holistic and legal approach to renegotiation is required. Such holistic and relational approach would look at both sides of the scale and the conduct of the parties in an evolutionary way in order to capture any opportunistic behavior of either of them throughout their contractual relationship, and prevent moral hazard due to the potential use of investment arbitration as an insurance mechanism.

The all the blurrier distinction between the contract and the treaty continues to emerge also in more recent case law. An example showing the strong interaction between the two instruments is a Polish case judged under the UNCITRAL rules, in which the tribunal found a breach of the Indian-Polish bilateral investment treaty (in particular, the expropriation provisions) due to the termination of a concession contract by a state-owned company, which, based on its actual functions, was deemed to be a “de facto” state organ.[241]

An ever more telling instance of the close connection (if not, often, inseparability) between the treaty and the underlying contract, is the ICSID case filed against Egypt by

[240] On contract as reference point, see Hart, O. (2008), *Contracts as Reference Points*, The Quarterly Journal of Economics, 123 (1): 1.

[241] https://www.iareporter.com/articles/in-new-bit-award-arbitrators-deem-state-owned-company-to-be-a-state-organ-and-see-fet-and-expropriation-violations-due-to-contract-termination/

the US company *Ampal-American Israel Corporation*.[242] The dispute ensued from the collapse of a politically-sensitive gas pipeline project, the Israel-Egypt pipeline, which has spawned multiple parallel arbitrations not only under ICSID but also under the ICC and UNCITRAL rules. In a broader application of the *res judicata* doctrine, the ICSID tribunal looked into the findings of the ICC tribunals in charge of the contractual disputes, in order to determine whether the alleged contractual breaches, and namely the contract's renegotiation, amounted to a breach of the above treaty.[243]

To this end, the tribunal found that there was no treaty breach because there was no coercion in the renegotiation of the contract. On the contrary, the investor was found to have acceded to the process and supported the renegotiation without opposing the proposals of the Egyptian authorities.[244] In this way, the tribunal adopted the criterion proposed in this thesis, i.e. that the "process itself" of the contract's renegotiation does matter, as a legal (and not merely factual) issue in determining whether there was a treaty breach.

The case is particularly interesting also for another reason, which backs one of the arguments made herein, and especially the proxy of mutuality. This is its emphasis on the corporate-governance implications of the investor's multinational operation, and the ensuing risk of forum shopping.[245] Citing the decisions in *RSM v. Grenada*[246] and *Apotex v. USA*,[247] the tribunal followed a reasoning deterrent of forum-shopping practices exploiting complex corporate-governance structures. More specifically, it agreed with the *RSM* and *Apotex* awards in their finding that foreign shareholder claimants are "privy of interest" with local corporate subsidiaries, and therefore held that cases involving the subsidiaries were *res judicata* for their owners.[248] Such approach takes a wider, relational-contract perspective on privity by incorporating other stakeholders' role in the implementation of the contract, namely that of the parent companies.[249]

Before advocating for an integrationist (as opposed to a self-contained) approach to the contract and the overarching treaty, and the merits of such approach for the interpretation

[242] *Ampal-American Israel Corporation and others v. Arab Republic of Egypt*, ICSID Case No. ARB/12/11, Decision on Liability and Heads of Loss, 21 February 2017.
[243] Id., paras 248 et seq.
[244] Id., para 210.
[245] In particular, the tribunal applied the doctrine of res judicata in an expansive manner, i.e. not only to the parties themselves but also those who are in privity of interest with them. Id., para 261.
[246] *RSM Production and Others v. Grenada,* ICSID Case No. ARB/10/6, Award, 10 December 2010
[247] *Apotex Holdings Inc. v. United States of America,* ICSID Case No. ARB(AF)/12/1, Award, 25 August 2014
[248] In particular, the tribunal applied the doctrine of res judicata in an expansive manner, i.e. not only to the parties themselves but also those who are in privity of interest with them. See *Ampal* award, *supra* note 243, para 261.
[249] https://www.iareporter.com/articles/in-new-egypt-ruling-disproportionate-contract-termination-and-failure-to-prevent-pipeline-attacks-underpin-fortier-chaired-tribunals-findings-of-bit-breach/

of investment treaties, the next section examines yet another connecting factor between the two instruments, and the implications that it has for the relationship between contract and treaty claims.

b) Umbrella clauses

The complexity of the contract-treaty relationship and the strong interconnection of the two instruments often leading to the *de facto* inseparability of claims ensuing therein is even more acute in cases where a treaty contains an umbrella clause, as show the diametrically different, and indeed contradictory findings reached in two related cases, the *SGS v. Pakistan*, and the *SGS v. Philippines*. Despite their emphasis on jurisdiction (which is out of the scope of this thesis), the awards are telling as regards the effect of an umbrella clause on the (potential) internationalization of the contract and the claims ensuing therein.

In *SGS v. Pakistan*, despite the battle of injunctions, the tribunal rejected Pakistan's objections to jurisdiction based on the exclusive compromissory clause in its contract with SGS, the essential basis test (as sanctioned in the *Vivendi* annulment decision), and the *lis pendens* rule due to the pending proceedings in its domestic fora. Rejecting Pakistan's arguments, the tribunal confirmed the dicta of the *Vivendi ad hoc* Committee on the independent existence of contract and treaty claims. At the same time it refused to entertain any contract claims by considering them excluded from the scope of both the BIT's compromissory clause and its umbrella clause. Regarding the latter, it held that despite its broad language it cannot be reasonably construed to encompass contract claims.[250]

Radically different was the decision in *SGS v. Philippines*[251] despite the factual and legal overlaps between the two cases. Unlike its *SGS v. Pakistan* counterpart, the *SGS v. Philippines* tribunal accepted the investor's broad interpretation of the umbrella clause as encompassing the observance by the host state of all its contractual commitments. Such interpretation was allegedly based on the text and the purpose of the Pakistani-Swiss BIT. The tribunal did not offer an explanation, though, for the opposite interpretation from the

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[250] *SGS Société Générale de Surveillance S.A. v. Pakistan*, Decision on Jurisdiction, ICSID Case No. ARB/01/13, 6 August 2003, paras 166-174.
[251] *SGS Société Générale de Surveillance S.A. v. Philippines*, Decision on Jurisdiction, ICSID Case No. ARB/02/6, 29 January 2004.

one given in the previous *SGS* case, despite the only minor differences in the texts of the two umbrella clauses.[252]

On the other hand, the tribunal held that the BIT compromissory clause was sufficiently broad to encompass both contract and treaty claims, thus reaching again the opposite conclusion from the *SGS v. Pakistan* case despite the nearly identical language of the two BITs. In spite of asserting jurisdiction, though, the tribunal held that it "should not exercise its jurisdiction over a contractual claim when the parties have already agreed on how such a claim is to be resolved, and have done so exclusively."

Taking an approach similar to the decision on the merits in *Vivendi*, it ruled that, "given the strong links between the contract claim and the treaty claim" (whose independent existence it doubted), it would have been "inappropriate and premature" to address the treaty claim before the contract claim was resolved in the domestic forum. It thus decided to stay the ICSID proceedings until the contract claim was resolved.[253]

Taking a look specifically at the disputes arising from the renegotiation of concession contracts, these also reveal inconsistencies in the interpretation of the umbrella clause. For example, in *Siemens v. Argentina* the tribunal held that the umbrella clause "has the meaning that its terms express, namely that failure to meet obligations undertaken by one of the Treaty parties in respect to any particular investment is converted by this clause into a breach of the Treaty". The tribunal went on to state that "it does not subscribe to the view... that investment agreements should be distinguished from concession agreements of an administrative nature, ... [because] the term "investment" ... linked as it is to "any obligations", would cover any binding commitment entered into by Argentina in respect of such investment." [254]

Similar was the approach in *LG&E v. Argentina*, which stated that an umbrella clause "creates a requirement for the host State to meet its obligations towards foreign investors, including those that derive from a contract",[255] as well as *Sempra v. Argentina*, holding that "the specific guarantee of a general 'umbrella clause' […] involves the obligation to observe contractual commitments concerning the investment." [256] Last, the tribunal in *Enron v. Argentina* ruled that "under its ordinary meaning the phrase "any obligation" refers to obligations regardless of their nature", but noted that "obligations" covered by

[252] Shany, Y. (2005), *Contract Claims vs. Treaty Claims: Mapping Conflicts between ICSID Decisions on Multisourced Investment Claims*, The American Journal of International Law, 99 (4): 835, at 841-842.
[253] See paras 155, 162-163, 175 of the *SGS v. Philippines* Decision on Jurisdiction.
[254] *Siemens A.G. v. Argentina*, ICSID Case No. ARB/02/8, Award, 6 February 2007, paras 204, 206.
[255] *LG&E Energy Corp. v. Argentina*, ICSID Case No. ARB/02/01, Decision on Liability, 3 October 2006, para 170.
[256] *Sempra Energy Int'l v. Argentina*, ICSID Case No. ARB/02/16, Decision on Objections to Jurisdiction 11 May 2005, para 101.

the 'umbrella clause' are nevertheless limited by their object: "with regard to investments." [257]

However, other decisions have taken a different approach.[258] In particular, the tribunal in *El Paso v. Argentina* interpreted the umbrella clause in the US-Argentina BIT as *not* extending "treaty protection to breaches of an ordinary commercial contract entered into by the State or a State-owned entity", but only to special "investment protections contractually agreed by the State as a sovereign - such as a stabilization clause - inserted in an investment agreement."

Similarly, the tribunal held that "an umbrella clause cannot transform any contract claim into a treaty claim, as this would necessarily imply that any commitments of the State in respect to investments, even the most minor ones, would be transformed into treaty claims." In other words, the decision drew a distinction regarding the state's capacity as a contractual party between *acta jure imperii* (falling under the umbrella clause) and *acta jure gestionis* (not covered by the umbrella clause).[259]

Similar was the finding in *CMS v. Argentina*, which held that "not all contract breaches result in breaches of the Treaty. The standard of protection of the Treaty will be engaged only when there is a specific breach of treaty rights and obligations or a violation of contract rights protected under the treaty. Purely commercial aspects of a contract might not be protected by the treaty in some situations, but the protection is likely to be available when there is significant interference by governments or public agencies with the rights of the investor." [260]

In summary, in line with the reasoning followed in *El Paso* and *CMS* (as well as *Pan American*, and *Joy Mining*),[261] the tribunals used the criterion of "sovereign interference" with the contract in order to distinguish between contract breaches (including renegotiations) covered by the umbrella clause, and breaches that any regular contractual party could commit, and where, consequently, the sovereign identity of one of the parties

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[257] *Enron Corp. v. Argentina*, ICSID Case No. ARB/01/3, Award, 22 May 2007, paras 273-274.

[258] Shenkman, E. & File, J. (2007), *Recent Developments in Investment Treaty Jurisprudence: Arbitrating Contract Claims under Umbrella Clauses*, Retrieved from: http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/Editorial/Publication/ShenkmanFile2007_intlarb.pdf, at 8

[259] *El Paso Energy Int'l Co. v. Argentina*, Decision on Jurisdiction, ICSID Case No. ARB/03/15, 27 April 2006, paras 79, 81, 82.

[260] *CMS Gas Transmission Co. v. Argentina*, Award, ICSID Case No. ARB/01/8, 25 April 2005, para 299.

[261] *Pan American Energy LLC v. Argentina*, Decision on Preliminary Objections, ICSID Case No. ARB/03/13, 27 July 2006, para 110. See also Joy Mining Machinery Ltd. v. Egypt, ICSID Case No. ARB/03/11, Award on Jurisdiction, 6 August 2004.

is only incidental. However, where the line is drawn between the two types of breaches is not clear.[262]

The differentiation is evidently more complex in the case of contracts incorporating the exercise of public power in and of themselves, as concession contracts are, wherein public power is (delicately) apportioned between the host state and the foreign investor – concessionaire. The ambivalence in case law regarding whether concession contracts are covered, as regular investment contracts of a commercial nature, by the umbrella clause, or are outside of its scope due to their public, administrative character, shows precisely this *sui generis*, hybrid nature of this type of contracts. Equally confusing are the different emphases of tribunals on those co-existing characteristics of concession contracts.

On the one hand, the *LG&E* tribunal referred to contractual provisions without distinction according to their nature as public or commercial, but held that the umbrella clause covers all contractual commitments that the host state has taken towards the investor.[263] On the other hand, the *El Paso* and *CMS* cases limited the scope of the umbrella clause based on the differentiation between *acta jure imperii* and *acta jure gestionis*, holding that only regulatory and not ordinary commercial contracts are covered by the clause.[264]

Another question arising from an interpretation of the umbrella clause covering the host state's contractual obligations reflects the dilemma between statism and dynamism, and refers in particular to the time at which the content of such contractual obligations is to be determined: is it the moment of the original formation of the contract, or the moment of the adjudication of the relevant treaty dispute, which means that the entire governance of the contract and its evolution should be taken into account in the relevant determination? The proxy of dynamism would clearly call for the second option. Moreover, the proxy of mutuality requires taking into account the contractual commitments in their entirety, which means that, in order to determine whether there has been a breach of the umbrella clause, the investor's conduct during the contract shall also be taken into account in interpreting the clause.

Putting the aforementioned, divergent awards in context, the conflicting conclusions that the tribunals reached cannot be explained by the minor textual differences in the formulation of the umbrella clause, but by the broader ideological divide between international judges and arbitrators over how to address the multiplicity of concurrent

[262] Shenkman, E. & File, J. (2007), *supra* note Recent Developments in Investment Treaty Jurisprudence: Arbitrating Contract Claims under Umbrella Clauses, Retrieved from: http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/Editorial/Publication/ShenkmanFile2007_intlarb.pdf, at 8
[263] See *LG&E*, *supra* note 256, para 170 & CMS *supra* note 261, para 298.
[264] See *El Paso supra* note 260, para 81.

legal sources and procedures, or in other words, the relationship between national and international law.

In this context, the *SGS v. Pakistan* decision epitomizes the "disintegrationist" approach, whereby legal dualism and the artificial separation between different legal regimes are used to interpret BITs as self-contained instruments. As exemplified by the conflicting decisions above as well as their failure to clearly indicate a criterion differentiating contractual breaches covered by the umbrella clause from those falling outside its scope, the "disintegrationist" approach downplays the practical problems arising from normative conflicts and parallel judicial proceedings.

Quite the reverse, the *SGS v. Philippines* award adopted a diametrically different, "integrationist" methodology, which acknowledges the effective relationship between the treaty and the underlying contract, and the inappropriateness – if not impossibility – of separating the two instruments. It is thus cognizant of legal pluralism, and aims to harmonize the ensuing overlapping norms by proposing a flexible, open-textured reading of BITs that encompasses a broad range of rights and obligations (including those arising from a contract), and expanding accordingly the jurisdiction of treaty tribunals.[265] Such a broader interpretative approach leaves also discretion to tribunals to look into broader areas of international and domestic legal systems alike, in order to identify general principles of international law appropriate for interpreting the vague treaty standards, such as the UNIDROIT Principles of International Commercial Contracts, analyzed below.

c) Legitimate expectations

Having examined the complex relationship between the contract and the treaty and the difficulties in distinguishing between contract and treaty claims, this section focuses on yet another connecting link between the treaty and the underlying contract, the doctrine of legitimate expectations. Little has been written about the relevance of legitimate expectations for connecting the contract with the treaty and their potential role as an entry point of relational-contract elements in the interpretation of the FET standard. The section concludes with certain recommendations for applying the doctrine using the relational interpretative proxies of mutuality and dynamism.

More specifically, as analyzed below, the application of the relational proxy of mutuality to interpreting "legitimate expectations" and, by implication FET, means *inter alia* taking into account the conduct not only of the host state, but also the investor in determining

[265] See Shany, Y., *supra* note 229, at 844-845.

whether any expectations were established, and if those were "legitimate". On the other hand, the proxy of dynamism gives the concept a dynamic temporal dimension that encompasses the entire evolution of the parties' contractual relationship, instead of "freezing the time" at the moment that the contract was signed.

As a preliminary note, the approach most commonly taken in investment arbitration has been the expansive interpretation of the investor's legitimate expectations, counterbalanced somehow by the consideration of competing interests through the use of other doctrines, external to the doctrine of legitimate expectations, such as the doctrine of proportionality. Arguing for a reform of the system from within (instead of importing concepts according to the policy preferences of alternative ideological camps), this thesis proposes a change in the interpretation of the doctrine itself, with a view to balancing the competing interests of the state and the investor already in defining the very content of "legitimate expectations".

Looking at the case law on "legitimate expectations", UNCTAD has categorized the relevant decisions along a spectrum ranging from a broad, yet rigid and static interpretation to a more balanced one placing several caveats on investors' expectations. Recognizing the tension between stability and adaptability, UNCTAD observes that the concept is linked to the phenomenon of "change", in the sense that investments are not one-off transactions, but are usually economic projects of long duration bearing considerable risks.[266]

The most extreme expression of the investor's rights approach is found in the *Tecmed v. Mexico* award. Adopting both a static and one-sided interpretation, the tribunal equaled the investor's "legitimate expectations" to a *de facto* freezing of any regulatory space for the host state. In particular, it held that, in light of the good faith principle established by international law, the host state shall not affect the basic expectations "that were taken into account" by the foreign investor "to make its investment". It also ruled that the investor expected the host state to act in a consistent manner, free from ambiguity and totally transparently in their relations, so that the investor may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.[267]

It is evident that the *Tecmed* definition of "legitimate expectations", apart from static and unbalanced is also untenable, as it promotes an absolute requirement for legal and

[266] See UNCTAD (2012), *supra* note Fair and Equitable Treatment, Retrieved from: http://unctad.org/en/Docs/unctaddiaeia2011d5_en.pdf, at 63.

[267] See *Tecnicas Medioambientales Tecmed S.A. v. The United Mexican States*, Award, ICSID Additional Facility Case No. ARB (AF)/00/2, 29 May 2003, para 154.

business stability. In *Douglas'* words, the *Tecmed* "standard" is actually not a standard at all, but rather a description of perfect public regulation in a perfect world, to which all states should aspire, but very few (if any) will ever attain.[268]

Nevertheless, other tribunals have followed the *Tecmed* approach, including in cases resulting from the renegotiation of (by definition, inherently incomplete and relational) concession contracts. In particular, the *CMS v. Argentina* and *Enron v. Argentina* awards found that the FET standard included a requirement for "a stable framework for the investment".[269] They held in this regard that Argentina's emergency measures were in violation of the standard, as they had dismantled the regime of tariff guarantees that had originally induced the investor to invest. Such interpretation does not show much regard for the conditions prevalent in the host state, which led Argentina to enact the disputed measures.

Similar were the findings in *PSEG v. Turkey* (also involving the renegotiation of a concession contract) where the tribunal likewise considered that any changes not only in the legislative framework but also in administrative attitudes and policies were contrary to the FET's requirement to ensure a stable and predictable business environment for investors to operate in, as required by the treaty.[270] It is not clear what the tribunal meant by reference to "attitudes" - a concept charged with subjectivity - whereas at the same time it held that there only needs to be an "objective" breach of FET. Moreover, in *Occidental v. Ecuador*, the tribunal went as far in sanctioning the stability requirement as part of FET, as to consider it also an element of the international-law minimum standard for the treatment of aliens.[271]

The excessive rigidity of the *Tecmed* criterion has led later tribunals to identify factors delimiting the scope of "legitimate expectations". For example, in *Duke Energy v. Ecuador* the tribunal pointed to the limitations to fair and equitable treatment, by emphasizing that the investor's expectations must be reasonable and legitimate. It also held that this assessment must take into account all circumstances, including political, socioeconomic, cultural and historical conditions prevailing in the host state, and the investor must have relied upon those conditions in deciding to invest.[272]

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[268] Douglas, Z. (2006), *Nothing if Not Critical for Investment Treaty Arbitration: Occidental, Eureko and Methanex,* Arbitration International, 22 (1): 27, at 28.

[269] See *CMS supra* note 261, para 274 & Enron, *supra* note 258, para 259.

[270] *PSEG v. Turkey*, *supra* note 220, Award, ICSID Case No. ARB/02/5, 19 January 2007, para 253.

[271] *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador*, ICSID Case No. ARB/06/11, Award, 5 October 2012, para 188.

[272] *Duke Energy Electroquil Partners & Electroquil S.A. v. Republic of Ecuador*, Award, ICSID Case No. ARB/04/19, 18 August 2008, para 340.

It is questionable how a concessionaire can claim that it relied on the stability of the concession's contractual and regulatory framework, when it has been itself the initiator of renegotiations, even soon after the award of the contract. On the other hand, the reference to "all circumstances" indicates a more holistic approach recognizing the embeddedness of the contract in the environment of the host state, and allowing for the accommodation of the relational proxies of mutuality and dynamism into the interpretation of "legitimate expectations".

Interpretative divergence has characterized also those decisions considering "specific representations" as an essential element of "legitimate expectations". In the *Methanex* dispute, the tribunal held that FET was not violated, as the United States government had not made any representations to the investor that it would not change its regulatory regime.[273]

EDF v. Romania also stressed the need for the specificity of promises or representations made to the investor, who could not rely on a treaty as an insurance policy against the risk of any legal and economic changes in the host state.[274] Arbitral awards along these lines suggest a stronger connection between the contract and the treaty, in particular by requiring the existence of a contract (or license or permit) between the investor and the host state,[275] or even stabilization clauses in the contract, in order to assert a finding on legitimate expectations. On the other hand, decisions such as *Enron v. Argentina*,[276] and *LG&E v. Argentina* took a rigid approach in equating with legitimate expectations guarantees included in the domestic legislation of the host state without requiring the existence of any specific relationship between the investor and the host state.[277]

Conversely, some tribunals have taken a procedural-justice perspective by upholding the host state's right to regulate in the public interest. Specifically, in *Saluka v. Czech Republic* the tribunal held that *bona fide* changes in the legislative and regulatory framework do not frustrate the investor's legitimate expectations, as long as they do not manifestly violate the requirements of consistency, transparency, even-handedness and non-discrimination. In particular, it stressed that the host state must never disregard the principles of procedural propriety and due process, and must grant the investor freedom from coercion or harassment by its own regulatory authorities.[278]

[273] *Methanex v. United States,* UNCITRAL Arbitration Rules (NAFTA), Final Award, 3 August 2005, Part IV, paras 8-9.
[274] *EDF (Services) Limited v. Romania*, ICSID Case No. ARB/05/13, Award, 8 October 2009, para 217.
[275] *Metalpar v. Argentina*, ICSID Case No. ARB/03/5, Award on the Merits, 6 June 2008, para. 186.
[276] See *Enron supra* note 258, para 103.
[277] See *LG&E supra* note 256, para 124.

[278] *Saluka v. Czech Republic*, Partial Award, UNCITRAL Rules, 17 March 2006, para. 308.

Similarly, in *Continent Casualty v. Argentina*, the tribunal rejected "legal stability" (mentioned in the preamble of the applicable BIT) as a component of the doctrine of legitimate expectations.[279] Of particular relevance herein is also the decision in *Vivendi v. Argentina II*. The tribunal there upheld the right of a newly elected government to reverse course and renegotiate its concession contracts, but emphasized the procedural aspect of such renegotiation process by stressing that renegotiations shall be transparent, non-coercive, and not based on threats of rescission of the contract.[280]

Also of relevance for the argument on the relational interpretation of FET is the series of awards taking into account also the conduct of the investor in deciding whether she had any expectations, and if those were legitimate. Among those are *Methanex*, which stressed the importance of "embeddedness" in the political economy of the host state, i.e. the need for the investor to have a general awareness of the regulatory environment in which it was operating, as a condition for the application of the legitimate expectations doctrine.[281]

The examination of the investor's conduct is essential in determining whether investment tribunals have adopted the relational proxy of mutuality in evaluating "legitimate expectations". Albeit scarce, there have been certain awards that have endorsed such a mutual interpretative methodology. For example, in *Thunderbird*, the tribunal rejected the claimant's argument on breach of its legitimate expectations, due to the fact that the investor knew that its investment was illegal under the domestic law of the host state.[282] Similar was the approach in *Fraport*,[283] where the tribunal also deemed the illegal conduct of the investor as a bar to claiming any legitimate expectations arising from its investment in the Philippines.[284]

Examples where case law has looked also into the conduct of the investor to give content to the doctrine of legitimate expectations are those of unconscionability, risk management, and reasonableness in conducting business. Particularly relevant is the award in *Azinian v. Mexico*, which involved a concession contract. The tribunal took into account the investors' business plan and held that the claimants had no resources of their

[279] *Continental Casualty v. Argentina*, Award, ICSID Case No. ARB/03/9, 5 September 2008, para 258.
[280] *Compañía de Aguas del Aconquija S.A. and Compagnie Générale des Eaux v. Argentine Republic*, Case No. ARB/97/3, Award, 20 August 2007, para 7.4.31.
[281] See *Methanex*, *supra* note 278, Chapter IV, para 9.
[282] *International Thunderbird Gaming Corporation v. the United Mexican States,* UNCITRAL Rules, 26 January 2006, paras 164-166.
[283] *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines*, ICSID Case No. ARB/03/25, Award, 16 August 2007.
[284] See *infra* Chapter IV on case law.

own that could be used to put the plan in operation, and had also failed to disclose material information to the regulatory authorities.[285]

As a result, the tribunal ruled that the withholding of information was unconscionable, and the local authority in charge of regulating the concession was entitled to expect more from the investors. It also decided that misrepresentations made by the investor regarding the prospects and manner of operation of the concession, in order to secure the relevant contract, can justify a termination of the concession contract without giving rise to a violation of the investor's legitimate expectations, and consequently, FET.[286] The tribunal thus adopted the proxy of mutuality in considering the investor's conduct to be also part of "legitimate expectations".

Diametrically different was the reasoning in *SPP v. Egypt*, where the tribunal shifted the burden of confirming the investor's competence to the host state, by holding that the Egyptian authorities had confirmed the company's experience before entering into the investment contract after extensive investigations.[287] As *Muchlinski* notes, this decision suggests that the host state has the obligation to ensure the truth of any material representations that the investor made about its competence, financial resources, and any other matter relevant for its investment.

Muchlinski observes in this regard that it is unclear how far such a duty may go, especially for developing countries with limited resources to engage in such investigation.[288] Besides, it has been the very scarcity of those resources that has led them to concession their public services to the private sector. Thus, it would be an oxymoron to accept that it is the developing status of certain states that pushes them to privatize their public services, but at the same time it is their responsibility to spend significant resources in verifying that the concessionaires have the necessary resources (and will) to manage the concession.

On the other hand, the *SPP* tribunal held that, had there been sufficient evidence that the investor had engaged in improper contacts or had exerted improper influence to secure or manage the investment contract, the host state would have had the right to vitiate the contract without this entailing any violation of the fair and equitable treatment obligation. This way the tribunal endorsed the proxy of mutuality in connecting the investor's contractual conduct with the interpretation of FET.

[285] *Azinian, Davitian & Baca v. Mexico*, ICSID Case No. ARB(AF) 97/2, Award, 1 November 1999, paras 31-32.
[286] Id., paras 108-110.
[287] *SPP v. Egypt,* ICSID Case No. ARB/84/3, Award, 20 May 1992, paras 124-125.
[288] Muchlinski, P. (2006) *"Caveat Investor"? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard*, The International and Comparative Law Quarterly, 55 (3): 527, at 537-538.

Closer to the proxy of mutuality was the award in *Genin v. Estonia*, where the tribunal held that there was a duty on the part of the investor for prudential cooperation and provision of information to the local authorities. In this context, it pointed to the lack of transparency of the investor regarding its corporate-governance structure, and in particular its failure to divulge the beneficial ownership of the parent company to the authorities.[289] The tribunal also highlighted the importance of the embeddedness of the investment into the environment of the host state, in the sense that a higher degree of candor and transparency is expected from the investor (as a good corporate citizen)[290] when it deals with a less developed economy.

A decision demonstrating the importance of the (re)negotiation "process itself" for the parties' contractual relationship, is the decision in *ELSI*,[291] where the ICJ looked at the context of negotiations, and in particular the conduct of the investor during those negotiations, to determine whether its claim against the host country was valid. The case is also particularly interesting due to its corporate-governance implications, which (albeit undervalued and underexplored) have concrete consequences for the initiation and the result of a renegotiation process. Although the electronics sector is certainly different from public utilities, by analogy, there are instances where the foreign investor is in a stronger bargaining position, because it can withdraw from the investment more easily than the host state or a domestic investor.

A case showing the relevance of the embeddedness of the investment in the environment of the host state for evaluating the investment's commercial feasibility, was *Olguin*, where the tribunal stressed that the investor could not complain of the shortcomings of the Paraguayan legal system, and held that it was evident that the investor, an accomplished businessperson with a track record as entrepreneur, was not unaware of the situation in Paraguay.[292]

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[289] *Genin v. Estonia*, ICSID Case No. ARB/92/2, Award, 25 June 2001, para 362.
[290] See Muchlinski, P., *supra* note 254, at 541.
[291] Case concerning *Elettronica Sicula S.p.A. (ELSI),* Judgment of 20 July 1989, ICJ Rep. 15.

[292] Olguin v. Paraguay, ICSID Case No. ARB/98/5, 26 July 2001, Para 65: "Lo que sí es evidente es que el señor Olguín, un avezado hombre de negocios, con una trayectoria empresarial de muchos años y una experiencia adquirida en el mundo de los negocios de varios países, no ignoraba la situación del Paraguay. Él tuvo sus razones (que este Tribunal no pretende juzgar) para invertir en ese país, pero no es aceptable que pretenda que se le indemnice por las pérdidas que sufrió al realizar una inversión espe- culativa o, en el mejor de los casos, poco prudente."

An extension of the investor's duty of due diligence is its duty to continue to manage its investment reasonably. This reasoning was endorsed both in the *ELSI* case and in *MTD v. Chile*, which held that the causation principle extends to the management of the investment following its establishment, and a claim for legitimate expectations and breach of fair and equitable treatment cannot be accepted for loss "attributed to the conduct of the investor." [293] The reference to the continuous duty of the investor to manage its investment responsibly is resonant of the relational proxy of dynamism that takes an evolutionary perspective on "legitimate expectations", as opposed to a static one that determines the content of the doctrine as frozen at the time that the investment was first made.

A related, important aspect, which can make the *ELSI* case serve as an example for a holistic and more balanced assessment of renegotiations in treaty-based disputes, is its emphasis on the evidence of the management of the investment by the foreign company, including the role of the parent companies in this regard. What is of particular relevance herein for demonstrating the relational character of concession contacts is the ICJ's emphasis on the wider stakeholder interests involved in evaluating ELSI's conduct as part of the FET standard.

The Court also emphasized the "arm-twisting" exerted on the Italian authorities to assist in the continued operation of the plant, which was never economically self-sufficient and had never paid any dividends.[294] Both elements touch on the core of the problem often characterizing concession contracts (as evidenced empirically), which is the mutual operation of the theory of obsolescing bargaining. In the context of complex, relational contracts, both sides can engage in rent-shifting behavior and demonstrate behavioral elements of opportunism and bounded rationality.

The mutuality-based reasoning of the *ELSI* case was also followed by ICSID in *Noble Ventures v. Romania*, where the tribunal rejected the investor's claim on breach of the FET standard, on the basis of the evaluation of the investor's own conduct. More specifically, it held that "the investor was as much to blame as the privatization authority", and noted that the company had refused to invest any of its funds in the restructuring process, and had defaulted on its bank loans that it had relied on exclusively to finance its investment.[295] Overall, the investor had failed to deliver on its own promises or, in other words, had not lived up to the legitimate expectations that it had

[293] *MTD Equity v. Republic of Chile*, Decision on the Application for Annulment, ICSID Case No. ARB/01/7, 21 March 2007, para 241

[294] See para 78 of the *ELSI* award.
[295] *Noble Ventures Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, para 152.

itself created to the host state, according to which it would participate in the privatization process candidly and effectively.

The idea that, along with the rewards come also risks for the investor, was endorsed (even indirectly) once again by the ICJ in the *Barcelona Traction* case. Judging whether the investor had a right to diplomatic protection by its home country, the Court held that states have a discretionary power to grant such protection or refuse it. It based this finding on the argument that it does not seem to be in any way inequitable that the advantages the investor drew from investing in a foreign state are counterbalanced by the risks ensuing from entrusting its protection to a state different from its home state.[296]

As *Muchlinski* observes, the ICJ's emphasis on the voluntary assumption of risks by the investor and the offsetting of those risks by the benefits drawn from investing in a foreign state, implies that such voluntary risk assumption shall be taken into account when determining whether the conduct of the host state is equitable or inequitable. In other words, adjudicators are encouraged to take a wider (or, in the terms used herein, relational) approach to interpreting the FET standard, by assessing the actions of the state in light of the benefits and burdens that underlie the undertaking of an investment.[297]

The argument could easily hold also for the investors that participated in the privatizations in Argentina before the eruption of the economic crisis. It can safely be concluded by the contractual arrangements for addressing the risk of their investments, and the premium tariffs investors were offered to operate in a country that had experienced economic hardship in the past, that the concessionaires in Argentina were well aware of the risky socio-economic environment which they chose to operate in.

It is interesting, though, to note the contrast between the relational reasoning of those ICJ tribunals and the more rigid and one-sided approach that most of the tribunals that dealt with the disputes ensuing from the Argentine financial crisis, took. Albeit outside of the scope of this thesis, it would be apposite to explore what led the latter to adopt an overly rigid interpretative methodology that did not take into account neither the conduct of the investor nor the "embeddedness" criterion in giving content to the doctrine of legitimate expectations and, concomitantly, finding whether there was a breach of the FET standard.

An explanatory factor could be the boom of cases that massively showered with (negative) publicity the renegotiation of the disputed concession contracts, and opened the door for the expansive use of treaty-based arbitration. Perhaps an even more telling explanatory factor is the way that the renegotiation process was conducted. Despite the

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[296] Case concerning the *Barcelona Traction, Light and Power Company, Limited,* Judgment of 5 February 1970, ICJ Reports 3, para 99.
[297] See para 547 of the *Barcelona Traction* award.

divergence and inconsistency in the approaches of the various tribunals, this is the key criterion that tribunals should have deployed to differentiate legitimate from non-legitimate renegotiations.

This factor has two facets, which correspond to the two aforementioned relational proxies: the first - based on the proxy of mutuality - relates to the way that the renegotiation process is conducted - orderly, transparent, and under the auspices of an independent mediator, as opposed to forced and politicized. The second - based on the proxy of dynamism - refers to the timing of the renegotiation - a legitimate measure to manage the crisis, as opposed to a procrastinated measure to take advantage of the crisis in order to shift rents from the investor to the government.

In other words, although an investment should be embedded in the socio-economic environment of the host state and shall not be used as an insurance mechanism for operating in riskier environments, there are fewer excuses for the state as regards political risks. Given the origins of investment treaties as mechanisms for the protection of foreign investors from political risks with the aim of preventing the politicization of economic disputes that the traditional means of diplomatic protection would entail, a differentiation between socio-economic embeddedness and political-risk protection must be the criterion distinguishing renegotiations that violate the investor's "legitimate expectations", thus breaching an investment treaty, from those that do not.

Of course "it takes two to tango" and a politicized environment in the host state can equally create "incentives" for opportunistic dealings not only to the government but also the foreign investor (as happened with investor-led renegotiations that took place before the Argentine crisis erupted). Consequently, in a similar way that the two relational proxies shall be used to interpret FET, they can also influence (in a backward induction) the incentives of the contractual parties while renegotiating in the shadow of investment treaties (and the potentially looming arbitral disputes). Knowing in advance that a subsequent arbitral tribunal would evaluate their conduct using the interpretative proxies of mutuality and dynamism, both parties would have an incentive to engage in good-faith renegotiations and adaptations of their contract.

In yet another backward induction, such a relational methodology would minimize not only moral hazard – during the implementation of the contract – but also adverse selection during the bidding selection process and award of the concession contract. Knowing that any effort to engage in shifting rents, namely through a contractual renegotiation (often requested shortly after the award of the concession) would be "penalized" both at the contractual and treaty-dispute phases, investors counting on renegotiations instead of the efficiency of their operations would be discouraged to bid for a concession contact.

As a result, a methodology based on relational contract theory would deter any frivolous, irresponsible, or opportunistic investors (especially in the sensitive and strategic sector of public utilities) and by extension, any subsequent, frivolous treaty claims, and would allow the investor-state dispute settlement system to play its role as an independent, effective, and "fair and equitable" system of resolving investment disputes.

Going back to the proxy of mutuality, in *Waste Management v. Mexico* (a treaty dispute that involved a concession contract) the tribunal assessed the conduct of the investor in order to decide whether the claimant had any "legitimate expectations" under the FET standard. In doing so, it rejected the concessionaire's claim that the host state had frustrated its legitimate expectations on the basis that it failed to meet its financial obligations towards the investor. Instead, it held that the investment was "not a good business decision and was not commercially viable in the first place." [298]

Moreover, the tribunal was sympathetic to Mexico's financial crisis, ruling that the non-payment of debts by the municipality to the concession was not due to any prejudice by the local authorities, but could be explained by the state's financial crisis, and that in any case the investor had recourse to local remedies to rectify the matter. It also emphasized the fact that the purpose of the investment treaty is neither to eliminate normal commercial risks nor to place the burden on the state to compensate the investor for the failure of its business plans. The tribunal added that a failing enterprise is not expropriated just because debts are not paid or other contractual obligations are not met.[299]

In conclusion, the proxy of mutuality in evaluating legitimate expectations as an alleged part of fair and equitable treatment is an expression of the principle "the person who seeks entity must do equity", and a corollary of the principle of good faith. Despite being neglected as an interpretative proxy by arbitral tribunals (many – but not all – of which have taken a rigid approach, akin to classical contract law) it is only reasonable to evaluate the conduct of both parties by determining whether the duty of "equity" has been breached. Such mutual, relational interpretation is already fully allowed by the current regime of investment arbitration, and does not even necessitate a major reform of the system. On the contrary, this interpretative option is ingrained in the generality and vagueness of the FET standard itself, and is thus left to the interpretative discretion of arbitrators to use.

The case law has been inconsistent also as regards the relational proxy of dynamism. As *Schreuer* notes, the relevant provisions in investment treaties do not define the time at which legitimate expectations must exist in order to be worthy of protection (in a similar

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[298] *Waste Management Inc. v. Mexico*, ICSID Case No. ARB(AF)00/3, Award, 30 April 2004, para 57.
[299] Id., para 177.

way as they do not make reference to the concept of legitimate expectations itself). However, relying on a number of arbitral decisions holding that expectations must rest on the conditions that exist at the time of the investment, he argues that this is the appropriate time for crystallizing the investor's legitimate expectations protected under the treaty.[300]

Schreuer cites in this regard the awards in *GAMI v. Mexico*, and *Tecmed v. Mexico*, both of which took such a static, classical-contract-law approach to legitimate expectations, holding that these are shaped on the basis of the law and the factual situation prevailing in the host country at the time that the investment was made. In *Tecmed* in particular, the tribunal held that treating international investments in a way that does not affect the basic expectations taken into account by the investor when it made its investment, is a result of the principle of good faith, as established in international law.[301]

He also observes that other tribunals have been even more explicit regarding the timing of expectations, with *LG&E v. Argentina* holding that Argentina interfered with expectations that were based on the license of the concessionaires and the surrounding laws and regulations in force at the time of the investment.[302] Similarly, in *Enron v. Argentina*, the tribunal noted that the protection of the expectations that were taken into account by the foreign investor to make the investment has been identified as a facet of the FET standard. Endorsing the static interpretative approach, it added that, what seems to be essential is that these expectations derived from the conditions offered by the state to the investor at the time of the investment, and such conditions were relied upon by the investor when deciding to invest.[303]

Similar was the interpretative approach in *BG v. Argentina*, which found that the duties of the host state must be examined in the light of the legal and business framework as represented to the investor at the time that it decided to invest. Likewise, in *National Grid v. Argentina*, the tribunal held that the FET standard protects the legitimate expectations of the investor at the time it made its investment, based on the representations, commitments, or specific conditions offered by the state concerned.

On the other hand, despite its argumentation for a static interpretation of legitimate expectations, *Schreuer* admits that an investment is more often than not a complex, evolving process. He refers in this regard to a series of awards, such as those issued in *CMS v. Argentina*, *Eureko v. Poland*, *Sempra v. Argentina*, and *BG v. Argentina*. In all

[300] Schreuer, C. & Kriebaum, U. (2009), *supra* note 149, at 2.
[301] See para 174 of the *Tecmed* award.
[302] See para 203 of the *LG&E* award: "It can be said that the investor's fair expectations have the following characteristics: they are based on the conditions offered by the host state at the time of the investment."
[303] See para 262 of the *Enron* award.

these cases the tribunals noted that investments can take place incrementally over time. Despite adopting the proxy of dynamism, though, they rejected at the same time the proxy of mutuality by emphasizing, in a one-sided way, the duty of the host state to continuously respect the investor's expectations, which are created as the investment evolves.

Schreuer deducts from the dynamic reasoning of such case law the doctrine of the "general unity of an investment operation", first set out in the ICSID case of *Holiday Inns v. Morocco*.[304] The classical formula for the doctrine also came from *CSOB v. Slovakia*, where the tribunal stressed that an investment is often a complex operation composed of various interrelated transactions forming an integral part of an overall operation qualifying as an investment.[305] Other awards, such as *Enron v. Argentina* and *Duke Energy v. Peru*, have looked, in order to define an investment giving rise to legitimate expectations, at the entire operation and the economic goal of an investment, rather than simply the distinct legal transactions composing it.

This holistic approach going beyond the isolated legal rights and looking, instead, at the overall economic operation of the investment, is resonant of the relational approach to investment contracts, which, in line with legal realism, does not confine itself to the "four corners" of the contract, but examines the entire economic operation of the contract, and the overall contractual relationship of the parties, as it evolves.

A result of the incremental and evolving nature of investments is – *Schreuer* notes – the difficulty in determining the time at which the legitimate expectations ensuing from such investment were established. To this end, *Schreuer* proposes a "multi-static" approach to ascertaining the existence of the investor's expectations, meaning that, for investments spreading over a period of time, the tribunal has to look at the time of "each individual" decision. Moreover, endorsing one-sidedness, the author argues that the host state may have created to the investor expectations not only at the time that it decides to invest, but also by any subsequent, favorable changes to the investment's framework.[306]

It is not clear why it is only favorable changes that the host state can enact, whereas it is precluded from effectuating any good-faith regulatory and legislative changes. Moreover, the author does not explain why he endorses a one-sided approach not looking also at the investor's conduct to determine whether the latter has any legitimate expectations. Such one-sided perspective stands in contrast with the scholar's holistic definition of investment as an economic, evolving relationship, and not a mere legal transaction.

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[304] *Holiday Inns v. Morocco*, ICSID Case No. ARB/72/1, Decision on Jurisdiction, 12 May 1974.
[305] *CSOB v. Slovakia,* ICSID Case No. ARB/97/4, Decision on Jurisdiction 24 May 1999, para 72.
[306] See Schreuer, S. & Kriebaum, U., *supra* note 149, at 8.

Equally unclear - if not an oxymoron - is why the author, despite admitting the typically complex and long-term nature of investment contracts, insists on the static approach and chooses to adjust it to the complexity of concession contracts simply by applying it at every single point in time when the investment evolves. Instead of such an artificial "multi-static" methodology, what is actually needed (or, to quote *Williamson*, the governance structure actually matching the nature of the transaction in a discriminating way) is a dynamic approach to legitimate expectations, which looks at the investment as a living instrument in its entirety, that is, from the time that it was made to the moment that the arbitral dispute is adjudicated.

This thesis takes issue both with the static and the one-sided perspective on legitimate expectations, and argues instead that legitimate expectations have to be defined and interpreted using the proxies of mutuality and dynamism. Such theorization of the concept is necessary, instead of relying exclusively on a selective choice of cases that produces unbalanced results.

As *Potestà* observes, a more robust methodology for defining legitimate expectations is needed rather than a mere reference to arbitral awards, which have themselves heavily relied on precedent without explaining their reasoning and attempting to theorize the concept. On the contrary, he notes that tribunals have given a content to legitimate expectations broader than the scope of the doctrine in domestic legal systems.[307] The wide discretion that arbitral tribunals possess to engage in interpretative fiat is demonstrated by the fact that the doctrine of legitimate expectations is not an established general principle of international law, at least with regard to its exact content.

For example, in the context of the ECJ case law, it is not national law and the terms of the contract that are taken into account as a mere factual matter in determining what the investor's legitimate expectations are. Quite the reverse, the presumption is that the legislative and regulatory framework of the host country will change, and it is the special circumstances of the economic actors involved that will be taken into account as a mere factual matter when implementing such change (and not *vice versa*).

This thesis is against the *Tecmed* rationale, according to which it is the principle of good faith, established in international law, that effectively equates the investor's legitimate expectations with the legal stability in the host state. On the contrary, it is precisely this same principle that calls for an evolutionary interpretation of investment treaties, in this case, of legitimate expectations as part of FET. As aforementioned, whoever seeks equity

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[307] Potestà, M. (2013), *Legitimate Expectations in Investment Treaty Law: Understanding the Roots and the Limits of a Controversial Concept*, Society of International Economic Law, 3rd Biennial Global Conference, at 89.

shall also do equity. When equity is sought on an evolving basis, both a dynamic and a mutual interpretation of legitimate expectations is called for.

d) The proposed solution: an integrationist approach

The tension between contract (claims) and treaty (claims) has also been well-evidenced in the literature. Recognizing that it has been one of the most controversial issues in international investment law, *Crawford* proposes an integrationist approach, developed within the framework of international law and premised on five relevant principles: the first two refer to the *a priori* non-limitation of the scope or content of treaty obligations, and the principle of *effet utile* requiring that differently worded provisions have different meaning.

The next three principles ensue from the law of state responsibility. This requires, first, that the disputed conduct is attributable to the host state, second, that the state has breached an international obligation – wherein the classification of its act as *jure gestionis* or *jure imperii* is irrelevant – and last, the characterization of an act as internationally wrongful is governed by international law, and is thus independent from the characterization of the same act (as potentially lawful) by internal law.

Citing examples of the integration of the contract with the treaty, *Crawford* refers to the finding of the English Court of Appeal in *Ecuador v. Occidental* holding that the separate agreement to arbitrate an investment claim under a BIT is a contract and not itself a treaty; nevertheless, it is incorporated in the treaty itself. In other words, the treaty breeds a contract. Another example refers to the integration of a dispute settlement clause into the investment contract at the exclusion of the treaty forum. In an observation endorsing the relational proxy of mutuality, *Crawford* highlights that the principle of *pacta sunt servanda* is not a one-way street, but shall also be respected by an investor invoking contractual jurisdiction based on an offer made by the state (as was decided in the *SGS v. Philippines* case).

Yet another instance testifying to the strong connection between the contract and the treaty is the possibility (yet limited) for the host state to raise counterclaims, on the condition that they arise from the same contract that gave rise to the treaty dispute.[308] Moreover, according to the *Saluka* case, in case that the respondent state raises in a counterclaim alleged breaches by the investor of the original share purchase agreement with the privatization agency, in order for such counterclaim to be legitimate, it must

[308] See Crawford, J. *supra* note 59, at 354-363.

have a close connection with the primary claim that it responds to.[309] Despite their rigidity, counterclaims are an illustration (albeit poor) of the relational proxy of mutuality, as they allow recourse (albeit limited) of the host state to the treaty forum to bring arguments about the investor's contractual conduct.

The last field that *Crawford* has identified as a connecting dot between the contract and the treaty is the doctrine of "legitimate expectations". He has endorsed in this regard the decision of the *ad hoc* Annulment Committee in *MTD v. Chile*, which held that "the TecMed Programme for good governance" is extreme and does not reflect international law. On the contrary - the Committee stressed - legitimate expectations generated as a result of the investor's dealings with the host state may be relevant for applying the guarantees incorporated in the investment treaty.

In other words, the obligations of the host state towards foreign investors derive from the terms of the applicable investment treaty and not from any set of expectations investors may have or claim to have.[310] As *Crawford* highlights, reference to a general and vague standard of legitimate expectations is "no substitute for contractual rights", and the relevance of such expectations is not a license for arbitral tribunals to rewrite the freely negotiated terms of the investment contracts. In this sense, "legitimate expectations" are anchored to the terms of the contract, as negotiated between the parties, thus incorporating an element of "mutuality".

Crawford concludes that contracts and treaties are "not clean different things", and there is no great gulf fixed between them. Although distinctions between legal systems should be observed, these should not come at the expense of "appropriate connections" between them. He highlights that such an "integrationist" approach has concrete legal repercussions both for the jurisdiction of arbitral tribunals and the merits of the relevant disputes. What the BIT does is to define an additional layer of protection for an investment. By contrast, it should not be used as a vehicle to rewrite the investment agreement.[311]

As regards specifically the merits, *Crawford* reminds that the investment contract is itself an allocation of risks and opportunities, and that "this allocation is relevant in determining whether there has been a breach of the fair and equitable treatment standard" in the first place. What this entails in particular for "legitimate expectations", is that the

[309] *Saluka Investments BV v. Czech Republic*, Decision on Jurisdiction over the Czech Republic's Counterclaim, Permanent Court of Arbitration, 7 May 2004, para 61.
[310] *MTD Equity v. Republic of Chile*, Decision on the Application for Annulment, ICSID Case No. ARB/01/7, 21 March 2007, paras 67, 69.
[311] See also Arato, J. (2016), *The Logic of Contract in the World of Investment Treaties*, William & Mary Law Review 58 (2): 351, at 370, 391, 398.

doctrine should "not be used as a substitute for the actual contract" between the parties nor as an overriding source of applicable law.[312]

These conclusions support the argument made herein, i.e. that the relationship between the contract and the treaty is a two-way street, and has effects flowing both ways. This means that it is not only the treaty that has legal effects on the underlying contracts (in particular by internationalizing them, as analyzed above). In reverse, these contracts also have legal consequences for the overarching treaty, especially for determining whether a breach of a treaty standard ensued from the implementation (including the renegotiation) of the underlying contract.

In addition to the proxy of "mutuality", the relational proxy of "dynamism", according to which the contract is a living instrument, entails *inter alia* that "the allocation of risks by contract" is relevant not only for determining whether a breach of treaty took place, but is also a dynamic process depending on the implementation of the contract and its potential renegotiation. By implication, a "renegotiation" that changes the allocation of risks between the parties must be taken into account not only for determining the rights and obligations of the parties under the contract, but also, by extension, for defining by means of a dynamic interpretation the content of the treaty standards, namely of "legitimate expectations" as part of the fair and equitable treatment standard.

The relational proxies of "mutuality" and "dynamism" are well-served by yet another connecting link between the contract and the treaty, favoring the application of contractual principles to the adjudication of treaty disputes. These principles are crystallized in the UNIDROIT Principles of International Commercial Contracts. The following section examines the emergence of the UNIDROIT Principles as relevant applicable law in investor-state dispute settlement, especially in cases involving the renegotiation of the underlying contracts on the basis of the general principle of "hardship".

3. The Use of the UNIDROIT Principles in International Dispute Resolution

a) The UNIDROIT Principles and Lex Mercatoria

The UNIDROIT Principles of International Commercial Contracts are alleged to be transnational rules forming part of the *lex mercatoria*. There is a lively and long-lasting

[312] See Crawford, J., *supra* note 59, at 373, 374.

debate on the content, methodological roots and particularly the appropriateness of the *lex mercatoria* as the law applicable to an international dispute. Although the analysis of the *lex mercatoria* debate is beyond the scope of this thesis, it is worth noting that the relevant criticism has focused mainly on the theory of "contrat sans loi" as a strong manifestation of the "laissez-faire" doctrine, or on the role of the *lex mercatoria* in filling lacunae of domestic laws. An example of the latter approach is the line of reasoning in *SPP v. Arab Republic of Egypt*, where the ICSID tribunal applied principles of international law on the basis that Egyptian law had gaps in regulating the calculation of interest.[313]

Both theories - unconditional supremacy of the contract and incompleteness of domestic laws - have been criticized as derogatory of national legal systems,[314] and have led to a dismissal of transnational rules as a genuine legal system characterized by completeness, structure, evolutionary ability, and predictability.[315] However, the *lex mercatoria* can legitimately apply to a dispute especially in the context of arbitration, which endorses the application of soft-law instruments more widely than national courts.[316]

Institutionalized arbitration is a central pillar in the formation and development of the *lex mercatoria*. Drawing from the systems theory and the theory of autopoiesis, *Teubner* regards the contract as an institution that externalizes the adjudication of its provisions to arbitrators. The assignment of adjudication to institutionalized arbitration, as opposed to *ad hoc* arbitrators, creates a new legal order transcending the individual contracts that arbitration is based on and forming a regime parallel to national legal systems.[317]

There are three primary ways in which arbitrators apply transnational rules: to identify the law applicable to the merits of the dispute (transnational choice of law rules), to address the merits of the dispute (substantive transnational rules), and to tackle transnational public-policy matters, in order to ensure the international effectiveness and enforceability of the arbitral award.[318] Apart from the application of transnational rules addressing the substance of a dispute, the *lex mercatoria* is also seen as a decision-

[313] See *SPP v. Egypt*, supra note 291.
[314] Gaillard, E. (1995), *Thirty years of Lex Mercatoria: Towards the Selective Application of Transnational Rules*, ICSID Review – Foreign Investment Law Journal, 10 (2): 208, at 212-217.
[315] Gaillard, E. (2001), *Transnational Law: A Legal System or a Method of Decision Making?* Arbitration International, 17 (1): 59, at 65.
[316] Saumier, G. (2012), *Designating the UNIDROIT Principles in International Dispute Resolution*, Uniform Law Review, 17: 533, at 547: "in the last 25 years, international arbitration has moved away from this traditional view, endorsing instead a broader target for the parties' choice of a governing set of "rules of law", widely understood to encompass what might also be referred to as non-State law."
[317] Teubner, G. (1997), *Global Bukowina: Legal Pluralism in the World Society*, in: Teubner, G. (Ed.), *Global Law Without a State*, Ashgate Publishing Company, at 11. See also Teubner, G. (2002), Breaking Frames: Economic Globalization and the Emergence of *lex mercatoria*, European Journal of Social Theory, 5: 199.
[318] Id., at 217-223.

making judicial process, during which arbitrators act to some extent as "social engineers", called to find innovative solutions to a dispute by weighing opposing considerations and taking "equity" into account.[319]

The *lex mercatoria* has been criticized for its a-national character and spontaneous[320] evolution as an autonomous, parallel legal order that is neither national nor international law, but a mixture of both systems. Several scholars remain cautious in its application, emphasizing the risk of exploiting its vagueness and self-regulatory rules "as an ideological cloak for self-interest" – especially in the context of economic development agreements.[321]

The traditional criticism launched against lex mercatoria is that, as "private" law it lacks democratic legitimacy and constitutional constraints.[322] A reply to this criticism is the argument that the *lex mercatoria* is developing its own constitution as a new form of international governance, whereby private ordering claims its own share in societal self-government and political organization.[323]

Along with spontaneity, this transnational body of rules is alleged to have its origins in the "need for effectiveness" of the law applicable to international economic relations.[324] The quest for rules especially tailored to address the needs of transnational commercial relations is traced back to medieval Europe, where the *lex mercatoria* was a "uniform system of law to regulate international commercial transactions, avoiding the vagaries of differing national systems." [325]

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[319] Lando, O. (1985), *The Lex Mercatoria in International Commercial Arbitration*, International and Comparative Law Quarterly, 34 (4): 747, at 752-755.

[320] Goldman, B. (1987), *The applicable law: general principles of law – the lex mercatoria*, in: Lew, J.DM (Ed.), *Contemporary Problems in International Arbitration*, Springer Link, at 114: "The criterion for determining the ambit of *lex mercatoria* that I would follow thus does not solely reside in the object of its constituent elements, but also in its *origin* and its *customary*, and thus *spontaneous* nature."

[321] Maniruzzaman, A. (1999), The Lex Mercatoria and International Contracts: Challenge for International Commercial Arbitration?, American University International Law Review, 14 (3): 657, at 676.

[322] Michaels, R. (2007), *The True Lex Mercatoria: Law Beyond the State*, Indiana Journal of Global Legal Studies, 14 (2): 447, at 451. See also Lurger, B. (1997), *Der Pluralismus der "lex mercatoria"*: Anmerkungen zu einem Aufsatz von Gunther Teubner, Rechtshistorisches Journal Bd., 16: 705, at 712: "Die lex mercatoria ist auch nicht so *inhaltsneutral* und *unpolitisch,* wie Teubner behauptet. […] Die *Gefahr des Machtmißbrauchs durch Private* ist gerade in einem informellen Norm-system wie jenem der lex mercatoria besonders groß*".*

[323] Zumbansen, P. (2002), *Piercing the Legal Veil: Commercial Arbitration and Transnational Law*, European Law Journal, 8 (3): 400, at 418-421.

[324] Dupuy, J.P. (1982), Legal Opinion to Aminoil, para. 26, in Aminoil Pleadings, *Kuwait v. Aminoil*, 21 I.L.M. 976.

[325] Redfern, A. & Hunter, M. (2004), *Law & Practice of International Commercial Arbitration*, Sweet and Maxwell, at 117.

During the 1960s there was a revitalization of the *lex mercatoria*, as academics started questioning the effectiveness of national law in international transactions.[326] This thesis shares the view of "the need for effective applicable law" in the settlement of disputes between states and foreign investors. It is along these lines that the argument made herein is in favor of legal rules facilitating the adaptation and renegotiation of international investment contracts, in order to accommodate changing circumstances and the effective governance of complex, long-term contracts.[327]

The UNIDROIT principles have been hailed as a "great milestone for the development of modern *lex mercatoria*",[328] and as forming part of the so-called third stage of evolution of the *lex mercatoria* or the "new *lex mercatoria*". The latter marks the transformation from informal and flexible soft-law norms to an established system of law with codified legal rules and general principles of law, as well as institutionalized arbitration for their adjudication.

The Principles share with the *lex mercatoria* the same perspective on the value of functionalism, legal realism and effectiveness, and flexibility in achieving a fair balance of the interests of the contracting parties. Other than this common conceptual background, the classification of the UNIDROIT Principles as a branch of the *lex mercatoria* is far from uncontestable.[329]

More specifically, the *lex mercatoria* is not to be conflated with the general principles of law crystallized in the body of the UNIDROIT Principles. While the doctrine of the *lex mercatoria* relies on the spontaneous creation of a-national legal rules by the community of merchants, general principles of law are rooted in national legal systems and identified through a comparative law analysis. Irrespective of the debate on the nature of the UNIDROIT Principles as part of the *lex mercatoria* or not, the focus herein is on one of the core features (and merits) of the Principles, that is, the crystallization of certain general principles of law and the balance of these principles with legal rules.[330]

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[326] Mazzacano, P. (2008), *The Lex Mercatoria as Autonomous Law*, Comparative Research in Law & Political Economy. Research Paper No. 29/2008, Retrieved from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1137629, at 14.
[327] On the characterization of lex mercatoria as "law in action", see Berger, K. (2010), *The Creeping Codification of the New Lex Mercatoria*, Kluwer Law International, at 212.
[328] See Maniruzzaman, A. *supra* note 283, at 677.
[329] Berger, K.P. (2000), *The Relationship between the UNIDROIT Principles of International Commercial Contracts and the new lex mercatoria*, Uniform Law Review, 5 (1): 153. On the UNIDROIT Principles as a Restatement of Global General Contract Law, of "global background law", see Michaels, R. (2014), *The UNIDROIT Principles as Global Background Law*, Uniform Law Review, 19: 643.
[330] Gaillard, E. (2011), *General Principles of Law in International Commercial Arbitration - Challenging the Myths,* World Arbitration & Mediation Review, 5 (2): 161 at 161-162.

The difference between these two categories of legal norms, principles and rules, is well established in legal theory. Whereas rules are subject to definite preconditions for their application, general principles are basic maxims, or "optimal" rules of fundamental importance for the progressive development of the law. The UNIDROIT Principles make use of the dialectic between legal rules and principles, by weighing the latter against the former, especially in those cases where broadly formulated rules require extensive interpretation and elaboration, thus leaving room for the teleological considerations that general principles offer.[331]

A characteristic example of such teleological and open-textured rules are the standards included in investment treaties, particularly the standard on fair and equitable treatment. The general principles crystallized in the UNIDROIT provisions have an active role to play in identifying the content and meaning of these standards, as well as adjudicating the disputes ensuing from their alleged breach. The emphasis below is on the balance between the rule of *pacta sunt servanda* and the general principle of hardship. Prior to analyzing the UNIDROIT provisions on hardship, it is apposite to examine the applicability of the Principles in international arbitration, and more specifically in the investor-state dispute settlement system.

b) *The Application of the UNIDROIT Principles in International Arbitration*

Arbitration is the dispute settlement mechanism most suited to accommodate the application of the UNIDROIT principles. The compatibility of the two instruments is emphasized in the very preamble of the Principles, where the parties wishing to choose the Principles as the rules of law governing their contract are advised to combine such choice-of-law clause with an arbitration agreement.[332] Unlike domestic courts, which are bound by the provisions of their own national law - including its conflict-of-law rules - arbitrators have more flexibility to apply a-national or transnational rules to the resolution of a dispute.[333]

There are three main ways in which the UNIDROIT Principles can apply in the context of international arbitration. The first is the incorporation of the Principles into the contract either in their entirety or by reference to specific provisions. This possibility is available not only for contracts *stricto sensu* but also for settlement agreements resulting

[331] Id., at 154-157.
[332] UNIDROIT Principles of International Commercial Contracts 2010, at 3.
[333] Bonell, M. (2000), *The UNIDROIT Principles and Transnational Law*, Uniform Law Review, 5 (2): 199, at 202-203.

from an arbitral dispute.[334] As contractual clauses, the application of the Principles is subject in this case to the limitations to freedom of contract stipulated in the applicable law.

An alternative, more assertive application of the Principles is their designation as the rules of law applicable to the dispute. Most arbitration laws allow for the application of non-state laws, as prescribed, for example, in article 42 of the ICSID Convention, article 28 of the UNCITRAL Model Law on International Commercial Arbitration, and article 33 of the UNCITRAL Arbitration Rules. Last, the third mode of application of the UNIDROIT principles - and the most relevant one for the analysis of investment-treaty disputes - is their potential application as "general principles of law" forming part of the international law applicable to the dispute.

The application of the Principles in commercial arbitration is well established and frequent in practice.[335] According to empirical data, 42% of the addressees of the CENTRAL Enquiry responded positively to the use of transnational rules in the context of international commercial arbitration. What is more, the addressees (a high number of whom were arbitration experts) drew a clear connection between commercial arbitration and the development of transnational law. Arbitration was regarded as the proper forum for comparative decision-making and the establishment of the new law merchant.[336]

A related and important finding is that practitioners (especially arbitrators) prefer to refer to a concrete and workable set of rules, like the UNIDROIT Principles, as opposed to the more nebulous concept of the *lex mercatoria*. The survey shows that the UNIDROIT Principles are popular in international legal practice and serve arbitrators to find "better" solutions in international commercial disputes. This empirical finding on the frequent use of the Principles in legal practice poses a challenge to the opponents of transnational commercial law, who base their arguments on the alleged rejection of the Principles in international legal practice.[337]

This does not mean, however, that the application of the Principles in international commercial arbitration is without problems. The hybrid nature of transnational legal rules

[334] Bonell, M.J. (2013) *supra* note 68, at 12.

[335] Reference to general principles of law has a long tradition in international arbitration. See Craig L., Park W., & Paulsson, J. (2000), *International Chamber of Commerce Arbitration*, Oxford University Press, at 333. See also Brunner, C. (2009), *Force Majeure and Hardship under General Contract Principles, Exemption for Non-Performance in International Arbitration*, Kluwer Law International, at 23.

[336] Berger, P., Dubberstein, H., Lehmann, S., & Petzold, V., *The CENTRAL Enquiry on the Use of Transnational Law in International Contract Law and Arbitration - Background, Procedure and Selected Results*, Retrieved from: https://www.trans-lex.org/3, at 9. See also Bonell, M. (2004), An International Restatement of Contract Law, The UNIDROIT Principles of International Commercial Contracts, Brill, at 241 et seq.

[337] See Berger, K. et al., *supra* note 298, at 9-10.

combining elements of commercial law and public international law, requires an interdisciplinary approach to mapping the exact content of the applicable transnational rules and making the deployment of the Principles functional.

The consolidation of transnational commercial provisions into the list of the UNIDROIT Principles lends credibility to transnational law as it provides a workable form for its application; arbitrators (and other practitioners) can refer with clarity to this codified body of provable legal standards.[338] However, such "statutory" codification comes at a cost for the flexibility, dynamism, and open-endedness of transnational commercial law, which are some of the fundamental foundations of this "third legal order".[339]

The objections to the very existence as well as the content of the *lex mercatoria* are even starker in the case of international investment arbitration. The involvement of the state in investment disputes gives the system a clear public-interest dimension drawing a strong connection between the resolution of the dispute and the application of the domestic law of the respondent state. The application of the national law of the host state can be justified in this context both on grounds of sovereignty and legal predictability.[340]

The former culminated in the establishment of the *Calvo* doctrine advocating the equal application of national law to both foreign and domestic investors on the basis of the principle of equality of nations.[341] The latter is explained by the well-developed structure of national law as an interconnected, interdependent collection of laws, regulations, and ordinances, enacted by the State and interpreted and applied by the courts; in other words a complete legal system, designed to provide an answer to any legal question possibly posed.[342]

On the other side of the scale balancing the role of international rules and norms against the national law of the host state, stands the theory of the "internationalization of state

[338] See Berger, K., *supra* note 289, at 232.
[339] Benson, B. (1989), *The Spontaneous Evolution of Commercial Law*, Retrieved from: http://myweb.fsu.edu/bbenson/SEJ1989.pdf, at 644, 654.
[340] Kjos, H. (2013), Applicable Law in Investor-State Arbitration, The Interplay between National and International Law, Oxford University Press, at 158, 163.
[341] Calvo, C. (1868), *Derecho Internacional Teórico y práctico de Europa y América,* D'Amyot, at 290-291: "*Una de las cuestiones más importantes de derecho internacional discutida en los tiempos modernos, es la referente a la responsabilidad que incumbe a los gobiernos por los daños y prejuicios que causen las facciones a los extranjeros. Es tan la importancia de este asunto, que su desenlace puede afectar no solo á los derechos internacionales de los Estados, sino también a la legislación propia, exclusiva, particular de cada pueblo. Si no establece que lo son, se llegará bien pronto en la práctica a crear un privilegio absurdo y funestísimo à favor de los Estados más poderosos y en contra de los débiles [...] Mas no supondría solamente lo que acabamos de decir, sino que equivaldría a conceder un privilegio injustificable a favor de los extranjeros y contrario a los naturales. Si estos no tienen derecho alguno a exigir que se les resarza de los daños y perjuicios que hayan sufrido ¿cómo han de tenerle los demás?*"
[342] Redfern, A., Hunter, J., et al. (2015), Redfern and Hunter on International Arbitration, Oxford University Press, at 229.

contracts", and more specifically, of economic development agreements. The aim of this section is, first, to position this theory within the broader framework of the *lex mercatoria* and, second and more importantly, to explore the role that the UNIDROIT principles, as a potential part of the *lex mercatoria* (albeit a much more concrete and well-defined set of principles), have to play in the adjudication of investment disputes involving state contracts, and especially their potential role for achieving a "fair and equitable" balance between the interests of the foreign investor and the host state for disputes arising from the renegotiation of such contracts.

The question whether the "international law of contracts" is part of transnational law or public international law, when state contracts are involved, is a highly contentious one. According to Professor *Goldman*, the "international law of the contracts" is part of the *lex mercatoria*, and thus an autonomous third legal order applying equally to state contracts and contracts between private parties.[343]

On the opposite side of the debate stand Professor *Dupuy* [344] and Professor *Weil*,[345] who remain skeptical of the application of the *lex mercatoria* to state contracts. For them the "international law of the contracts" is a specific legal regime applying to state contracts and constituting a branch of public international law.[346] On the other hand, *Jessup* [347] and *Fatouros* [348] take a more nuanced view on the character of the law of state contracts. According to them, the law of state contracts is nothing but a species falling under the genus of "transnational law" together with other species, such as the traditional public international law, private international law, and international administrative law.

Against the background of the debate on the content of transnational law and its potential applicability to state contracts, the question on the application of the UNIDROIT Principles to contracts between host states and foreign investors assumes particular importance. The main consequences resulting from the application of the Principles in this context relate to the "legal standard applicable to the renegotiation of the state contracts" in question.

As analyzed below, while the strict and narrow legal standard of the "defense of necessity" is applicable under traditional public international law, the legal standard relevant under the UNIDROIT principles is that of "hardship". The difference between

[343] Goldman, B. (1983), *Lex Mercatoria*, Springer, at 1-24.
[344] *Texaco Overseas Petroleum Co. v. Libyan Arab Rep*., Judgment of 19 January 1977, 53 I.L.R. 389, 446-49.
[345] Weil, P. (1982), *Principes Généraux du Droit et Contrats d'État*, in: *Le Droit des Relations Economiques Internationales, Etudes Offertes à Berthold Goldman*, Paris: Litec DL at 406-407.
[346] See Maniruzzaman, A. *supra* note 283, at 662.
[347] Jessup, P. (1956), Transnational Law, New Haven: Yale University Press, at 136.
[348] Fatouros, A. (1962), Government Guarantees to Foreign Investors, Columbia University Press, at 287.

the two defenses is examined in the following section, where the content of "hardship" is also mapped, along with its potential status as a "general principle of international law".

c) *The Relevance of the UNIDROIT Principles in Investor-State Dispute Settlement*

i) The UNIDROIT Principles as General Principles of International Law

Given the distinct and autonomous role of international law as applicable law in investment-treaty disputes, identifying international legal rules that achieve a fair balance between the public and the private interests is of crucial importance for the just resolution of a dispute and the ultimate survival of the arbitration system. The annulment decisions in *Vivendi II* and *Wena v. Egypt* marked the autonomy of international law as applicable law in treaty-based disputes; the first separated contract claims from treaty claims[349] and the second held that "international law can be applied by itself, if the appropriate rule is found in this ambit." [350]

In light of the above jurisprudential developments, arbitrators have the discretion to apply international law to certain matters at the exclusion of domestic law. When this matter is the renegotiation of a state contract, proper international rules accounting for local realities and the relationship of the parties as it evolved during the life of the contract, are needed.

The UNIDROIT provisions offer some pertinent and useful rules for connecting the two (*de facto* strongly interrelated) instruments, the contract and the treaty, particularly with regard to contractual renegotiations resulting from corruption, gross disparity, or hardship. Such renegotiations should have an impact on the adjudication of claims based

[349] *Compañia de Aguas del Aconquija, S.A. v. Argentina*, Decision on Annulment, *supra* note 224, ICSID No ARB/97/3, 3 July 2002, para 96: "Whether there has been a breach of the BIT and whether there has been a breach of the contract are different questions. Each of these claims will be determined by reference to its own proper or applicable law—in the case of the BIT, by international law, in the case of the Concession Contract, by the proper law of the contract, in other words, the law of Tucumán". See also Shany, Y. (2005), *supra* note 255, *Contract Claims vs. Treaty Claims: Mapping Conflicts between ICSID Decisions on Multisourced Investment Claims*, The American Journal of International Law, 99 (4): 835, at 839.

[350] See *Wena Hotels Ltd. supra* note 234 *v. Arab Republic of Egypt*, Decision on Application for Annulment, ICSID Case No. ARB/98/4, 5 February 2002, paras 941-942. In a similar line, see also the awards in *Azurix v. Argentina*, ICSID Case No ARB/01/12, 14 July 2006, paras 65-68, *El Paso v. Argentina*, ICSID Case No. ARB/03/15, 27 April 2006, paras 128-141, and *Santa Elena v. Costa Rica,* ICSID Case No. ARB/96/1, 17 February 2000, para 40.

on treaty standards and those UNIDROIT Principles constituting general principles of international law can help achieve such a treaty-contract connection.

Of the three aforementioned modes of application of the UNIDROIT principles, the most relevant for the purposes of the adjudication of investor-state disputes is their relevance as "general principles of law" forming part of the applicable international law.[351] The preliminary question arising in this context is whether the UNIDROIT Principles have the status of "general principles of law", and can thus be part of the applicable international law, pursuant to Article 38 (1) (c) of the ICJ statute. The United Nations Compensation Commission has referred to the UNIDROIT provisions as an expression of general principles, particularly with regard to force majeure.[352]

However, not all the UNIDROIT Principles have the same status as general principles of law. While for the most part the Principles "reflect concepts to be found in many, if not all, legal systems, they are also intended to provide a system of rules tailored to the needs of international commercial transactions. Thus, they also embody what are perceived to be best solutions, even if not yet generally adopted." [353]

This perspective of optimal, emerging solutions is particularly relevant in the evolving field of international investment law, where general principles are still nascent and under formation.[354] Arbitrators are in a position to contribute to the development of general principles of investment law thanks to the flexibility they have while judging open-textured treaty standards.

This means that they are not bound by the rigid prescriptions of a comparative-law approach, let alone by the provisions of a single, foreign domestic law, for example the French provisions on *imprévision*. On the contrary, in order for a general principle to apply in the field of public international law, it may need to be suitably adapted,[355] and its

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[351] International law is applicable under most arbitration laws regulating investor-state arbitration. See *inter alia*, Article 42 of the ICSID Convention and Article 33 of the UNCITRAL Arbitration Rules.

[352] United Nations Compensation Commission 18 December 1997, UN-Doc S/AC.26/1997/6, at 23, 27, 32. See also Scherer, M. (2009), *The Use of the PICC in Arbitration*, in: Vogenauer, S. & Kleinheisterkamp, J. (Eds), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC),* Oxford University Press, at 102.

[353] UNIDROIT Principles of International Commercial Contracts 2010, at xxiii.

[354] It is also a common theme in the field of international law in general. See International Law Commission (2011), *Draft Articles on the Responsibility of International Organizations, with Commentaries*, at 2: "The fact that several of the present draft articles are based on limited practice moves the border between *codification* and *progressive development* in the direction of the latter." Emphasis added.

[355] Guillaume, G. (2008*), Can Arbitral Awards Constitute a Source of International Law under Article 38 of the Statute of the International Court of Justice*?, in: Banifetami, Y. (Ed.), *Precedent in International Arbitration,* International Arbitration Institute, Juris Publishing Inc., at 106: "while general principles of public international law are enshrined in international custom, […] general principles of law are common to national legal systems and transposable to public international law". On the other hand, see Crawford, J.

content, as identified through a comparative analysis of national legal systems, may change when applied at the level of international law.[356]

Apart from the potential direct application of the UNIDROIT provisions as general principles of international law, the Principles can also be relevant as "interpretative tools" of the international investment treaty in question. Pursuant to article 31 of the Vienna Convention on the Law of Treaties, any relevant rules of international law applicable in the relations between the parties shall be taken into account in the interpretation of the treaty in question. These interpretative means correspond to the sources of international law in article 38 (1) of the ICJ Statute.[357] Thus, general principles of international law (as recognized in article 38 of the ICJ Statute) may be included among the rules relevant for the interpretation of an international investment treaty.[358]

A balanced interpretation of investment treaties, which reads limits to the protection of investors into the applicable treaty standards, is of crucial importance given the open-textured character of the standards in question. Of particular relevance for evaluating the potential role of the UNIDROIT principles in such interpretative exercise is the vague standard of fair and equitable treatment. The UNIDROIT Principles can prove useful in several ways for evaluating the breach or non-breach of the fair-and-equitable treatment standard in the face of a renegotiation of a state contract due to hardship.

The relevance of the Principles was recognized, *inter alia*, in the dissenting opinion of arbitrator *Pedro Nikken* in the *Suez v. Argentina* case. *Nikken* made an explicit (albeit passing) reference to the obligation of the investor to negotiate the adaptation of its contract with the state in the face of hardship, and consequently, the non-violation of the fair and equitable treatment standard due to such a contractual renegotiation. What is even more important is that Nikken referred to the hardship provisions of the UNIDROIT

(2012), *Brownlie's Principles of Public International Law*, Oxford University Press, at 37 contending that "general principles of international law" may refer to general principles of law as in Article 38(1)(c).

[356] Cordero-Moss, G. & Behn, D. (2014), *The relevance of the UNIDROIT Principles in investment arbitration,* Uniform Law Review, 19 (4): 570, at 587. An example of the different content of a principle under national laws as compared with international law is the principle of good faith. While the ICJ found that unilateral promises are binding in international law, under the principle of good faith, this is not the case under English contract law.

[357] Waldock Report VI, YBILC 1966 II 97, para 10.

[358] ILC Report 1964, YBILC1964 II 202 f, para 11, as well as ILC, YBILC 1966 ½ 188, para. 49. See also Wälde T. (2009), *Interpreting Investment Treaties,* in: Binder, C. et al. (Eds), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer*, Oxford Scholarship Online, at 724, 746: "the notion of "international law" as set out in Article 31(3)(c) is not sufficiently narrow to exclude instruments of international law that harmonise international commercial law, for example, the UNIDROIT Principles of International Commercial Contracts, to assist in understanding interpretation of investment treaty terms. […] While the "*lex mercatoria*" as an expression of international business custom is far from the vision of public international lawyers, the wide reference to "international law" in Article 31(3)(c) and the tripartite nature of investment arbitration including a non-State element does not preclude taking account of non-traditional sources of international law."

Principles as the "international standard", and a corollary of the principle of good faith, against which the contractual renegotiation and the ensuing alleged breach of the FET standard should be assessed.[359]

The deployment of the UNIDROIT Principles in the field of investment arbitration can contribute to the development of the general principles of international investment law and increase their uniform and consistent application.[360] As codified rules, the UNIDROIT principles present more clarity than unwritten general principles of the *lex mercatoria*, and thus, if consistently applied, can constitute a concrete point of reference, and contribute to increasing the legal stability and predictability of arbitral decisions.

Before analyzing the defense of hardship under the UNIDROIT principles and its potential status as a general principle of law applicable in investor-state disputes, it is apposite to explain the relevance of the Principles for investment contracts, and particularly state contracts, as well as their application in the context of arbitral disputes between host states and foreign investors. The following section aims to establish two links between the UNIDROIT principles and investor-state arbitration: their relevance for investment contracts and their application to state contracts in particular.

ii) The UNIDROIT Principles and International Investment Contracts

While most of court decisions and arbitral awards make reference to the UNIDROIT Principles in the context of sales contracts or other one-off transactions,[361] there is an increasing recognition of the relevance of the Principles for the governance and adjudication of long-term contracts, and particularly investment contracts. The application of the Principles to this specific category of transactions is stated explicitly in

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[359] See the Dissenting Opinion of arbitrator Pedro Nikken in the *Suez v. Argentina* case. To be noted, the UNIDROIT principles were also of direct influence for the formation of contract law in the new Argentinian Civil Code.

[360] On the relevance and importance of general principles of law in international investment law, see Gazzini, T. (2009), *General Principles of Law in the Field of Foreign Investment*, Brill Online Books and Journals, at 103: "An attempt is made to draw some light on the controversial yet challenging question of the adequacy of international law and domestic law to govern foreign investment and the alleged necessity of a third legal order", and at 105: "The general principles of law relate to the interaction between international law and the generality of national legal systems. […] General principles of law derived from municipal system interact with the other sources of international law too. They may develop into customary rules, find their way into treaties, or fill the gaps of both treaties and customs". On the contribution of general principles to the continuing evolution of international law, see Pellet, A. (2012) *Statute of the International Court of Justice*, in: Zimmermann, A., Tomuschat, C., Oellers-Frahm, K., Tams, C. (Eds), *The Statute of the International Court of Justice: A Commentary,* Oxford University Press, at 850.

[361] On the distinction between one-off transactions or classical contracts, neoclassical contracts, and relational, long-term contracts, as well as the important legal implications resulting from this distinction for the governance of the relevant contracts, see *supra* Chapter II.

the body of the relevant instrument.[362] Their growing importance for the effective operation of long-term contracts confirms the interest of the Governing Council of UNIDROIT to introduce certain amendments to the Principles that tailoring their black-letter rules and comments thereof to the special needs of long-term contracts.

The relevant Working Group convened in late January 2015 and deliberated on the basis of Professor *Bonell's* position paper on the application of the Principles to long-term contracts. The axes around which the paper revolved are those highlighting the specific characteristics of long-term contracts and the ensuing need for their sustainable governance. These axes were the often relational character of long-term contracts, the requirement for the good faith cooperation of the parties and the regular need for renegotiation and adaptation of the contract. Particular emphasis was placed on hardship and its legal consequences, namely the availability of the remedy of renegotiation as a result of the occurrence of hardship. What is even more important is the attention paid to the regulation of the "renegotiation process itself" as a prerequisite to resorting to a dispute resolution system.

Among the recommendations put forward was the addition of a new Comment to Article 2.1.15 stipulating the obligation to renegotiate in good faith as the first step to the resolution of a dispute, as well as specific contingencies that would trigger the renegotiation remedy, with hardship figuring prominently among them. Even more important, both in procedural terms and with regard to the legal effects produced in case of the adjudication of a supervening dispute, was the proposal to denote the specific obligations deriving from the overarching duty to renegotiate in good faith, as well as the legal consequences from a breach of these obligations.

Among the proposed specifications of the duty to renegotiate in good faith were, first, the guidelines already included in Comment 5 to Article 6.2.3 on hardship, i.e. that both parties must conduct the renegotiations in a constructive manner, in particular by refraining from any form of obstruction and by providing all necessary information.[363] In addition to these guidelines, the Working Group indicated several other obligations of the renegotiating parties, particularly their duty to make concrete and reasonable suggestions for adjustments instead of just generic declarations of good will; to give appropriate reasons for such suggestions; to obtain expert advice in difficult and complex consensus-building proceedings; and to avoid an unfair advantage or detriment to the other side.[364]

[362] See the Preamble of the UNIDROIT Principles of International Commercial Contracts 2010, at 2: "The Principles do not provide any express definition, but the assumption is that the concept of "commercial" contracts should be understood in the broadest possible sense, so as to include not only trade transactions for the supply or exchange of goods or services, but also other types of economic transactions, such as *investment and/or concession agreements* […]". Emphasis added.
[363] Article 6.2.3, Comment 5, UNIDROIT Principles of International Commercial Contracts 2010, at 220.
[364] Bonell, M. (2014), *supra* note 69, at 5-6.

This last requirement clearly echoes the argument made herein on the economization of the transaction cost of opportunism, manifested particularly by the unfair capture of the renegotiation surplus by one of the parties.

With regard to the procedural criteria of the duty to renegotiate in good faith, Professor *Cordero Moss* illustrated her experience with contracts in which the parties had regulated the renegotiation procedure and had linked its observance with their obligation for good-faith conduct. According to her view, the UNIDROIT Principles could include a provision instructing the parties to describe in their contract the procedure to be followed in order to comply with their duty to conduct a good-faith renegotiation.[365] In a similar vein, Professor *Fontaine* proposed the establishment of a permanent structure, such as a "contract management committee" [366] charged with the supervision of the evolution of the contract and with making recommendations for needed adaptations going even beyond major disturbances, such as hardship and force majeure.

In connection with the proposed establishment of a contract management committee and in a demonstration of the strong relationship between the renegotiation process and the subsequent dispute-resolution process, Professor *Zimmermann* recommended "mediation" prior to resorting to any dispute resolution process. More specifically, *Zimmermann* proposed that the failure of a contractual renegotiation between the parties to produce a mutually satisfactory solution should yield the floor to a "second-level renegotiation" process conducted through independent "mediation". The mediation task would be assigned to a qualified third party that would assist the parties to reach an agreement in order to prevent the escalation of the dispute and the resort to arbitral or judicial proceedings.[367]

As expected,[368] central in the discussion on the modification of the UNIDROIT Principles in order for them to cover the special needs of long-term contracts, was the concept of hardship. *Bonell* introduced the concept with the observation that long-term contracts are by nature subject to supervening events. Whereas *force majeure* aims at the termination of the contract and the exoneration of the suffering party from liability, the rationale behind the mechanism of hardship is to modify obligations that have become too onerous to observe in light of the new contractual equilibrium, and to keep the contractual relationship alive on modified terms.

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[365] UNIDROIT Secretariat (2015), Principles of International Commercial Contracts, Working Group on Long-Term Contracts, Study L – Misc. 31 Rev., at 8.

[366] Id., at 7-8. A similarity of a committee of this type with the regulator of a utilities contract is the active role of both types of supervisors in contractual amendments. An important difference, though, lies in the level of their independence.

[367] Id., at 9.

[368] Following the predictions of the theoretical analysis on the three-way classification of contractual arrangements and the nature of long-term investment contracts in infrastructure, as developed above.

Seppälä noted that there is a trend towards accepting hardship in national laws; for example, in France there was a bill making "imprévision" applicable not only in public but also in private contracts. The Secretary-General of the UNIDROIT pointed to the UNCITRAL Guide on Privately Financed Infrastructure Projects[369] as another example of legal rules embracing the possibility of change in circumstances, either in regulatory or economic terms. He noted as a caveat, though, for the use of the hardship defense the non-universal acceptability of the provisions on hardship. Moreover, *Chappuis* drew attention to the element of risk. She remarked that hardship can be invoked on the condition that the risk of the event had not been assumed by the disadvantaged party.[370]

iii) The Relevance of the UNIDROIT Principles for State Contracts

Having established the application of the Principles to international investment contracts, this section takes the analysis a step further and addresses the question of the suitability of the Principles for investment contracts, when one of the contracting parties is a state and the other a foreign investor. In order to address this question, two issues are of relevance: on the one hand, the application of general principles of law to contracts between host states and foreign investors is alleged to put the contractual relationship on a more equal footing. This is due to the fact that the investor is reluctant to submit to local law, while the state is equally reluctant to submit to foreign law.

Thus, as *Bonell* notes, it is common for concession agreements or other types of economic-development agreements to make reference to vague constructs such as "general principles" or "fairness". This choice-of-law technique is a compromise between the interests of the parties to apply the local or, reversely, foreign law to their relationship. However, it comes at a cost for legal clarity and predictability. Given the vagueness of "general principles of law", the UNIDROIT Principles have been taken as a convenient statement of the content of such general principles.

The key question, though, that *Crawford* asks, is whether the UNIDROIT Principles are the appropriate legal instrument to apply to state contracts - particularly major economic-development contracts - given the specificities of the latter. The long-term and often conflicting interests of the parties involved require rules that can best address the transaction costs of bounded rationality and opportunism and align the incentives of the parties with a view to achieving their enduring cooperation.

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[369] UNCITRAL (2001), *Legislative Guide on Privately Financed Infrastructure Projects*, Retrieved from: https://www.uncitral.org/pdf/english/texts/procurem/pfip/guide/pfip-e.pdf,_at 140 et seq.
[370] See *supra* note, 363, at 12-13, 21.

This rationale is the central thread of analysis underlying the present thesis. The main conflicting interests of the parties are, on the one hand, the public resources of the host state and the fact that the contractual relationship takes place in its territory and within the framework of its administrative system, and on the other hand, the substantial up-front capital commitment that the foreign investor usually makes.[371]

Arbitral practice attests to the relevance of the Principles in the adjudication of state contracts. In the ICC decision 7110 the tribunal concluded that by agreeing to international commercial arbitration, the parties (an English supplier and a Middle Eastern governmental agency) intended the application of general legal rules and principles to govern their contracts. The tribunal also found that the UNIDROIT Principles were relevant in that context as embodying these general rules and principles applying to international contracts and enjoying international consensus.[372]

Among the thorny questions regarding the suitability of the Principles for state contracts, is the invocation of *force majeure* or hardship by a state entity-party to the contract due to acts attributed to the state. In this case there is a risk of manipulation and state interference, when the separate legal identity of the state entity is used to evade contractual obligations. Evoking *force majeure* may be an abuse of the remedy, if the state established the separate entity and subsequently made it intentionally impossible for it to fulfill its contractual obligations. The cousin provision, the remedy of hardship, will be examined in detail in the following section.

Before moving to the UNIDROIT provisions on hardship, which address directly the issue of contractual renegotiations, it is apposite to recall some other provisions addressing the contours of renegotiation and making the UNIDROIT Principles appropriate for state contracts. These provisions are Principle 3.2.7 on gross disparity between the parties in terms of bargaining power and negotiating position, and Principle 3.3.1 on corruption. Both can have substantial effects on the renegotiation process as well as on determining the content of the doctrine of "legitimate expectations" and the "fair and equitable treatment" standard.

The significance of the UNIDROIT Principles, including those on hardship, has been recognized in recent arbitral case. Given the hybrid character of investor-state arbitration as a public-private regime as well as the hybrid nature of investor-state contracts as both regulatory (public) and commercial (private) contracts, there is a need for legal tools

[371] Crawford, J. & Sinclair, A. (2002), The UNIDROIT Principles and their Application to State Contracts, UNIDROIT Principles of International Contracts. Reflections on their Use in International Arbitration, ICC International Court of Arbitration Bulletin, Special Supplement, at 58. See for example the awards in the ICC cases 7110 and 9029.
[372] See also the Principles of European Contract Law, Retrieved from: https://www.trans-lex.org/400200/_/pecl/

corresponding to such a hybrid scheme. The general principles of law codified in the UNIDROIT Principles serve the purpose of complementing the public-international law rules applied in the adjudication of investor-state disputes.

Several arbitral awards have referred to the UNIDROIT Principles as a codification of general principles of law applicable to state contracts. For example, in the ICC case No. 7110 the tribunal held that the Principles reflect general rules and principles of law covering international contractual obligations and enjoying a wide international consensus.[373] Similarly, in *Cubic* the tribunal turned to the UNIDROIT Principles to impart meaning to general principles of international law, and found, in particular, that the right of any of the parties to request the adaptation of their contract due to hardship, is a general principle of law applicable "even if not recognized by the domestic law", in that case, the law of Iran.[374]

The *Cubic* tribunal's findings were sanctioned by the US courts, which stressed that the tribunal's application of the UNIDROIT Principles, such as those of good faith and fair dealing formed part of the law applicable to the dispute.[375] The following sections examine the arbitral cases that have deployed the UNIDROIT Principles for the resolution of treaty-based disputes, with a particular emphasis on contractual renegotiations due to the occurrence of hardship.

iv) The Application of the UNIDROIT Principles in Investor-State Dispute Settlement

While the applicability of the UNIDROIT Principles in international investment arbitration based on contractual claims does not present difficulties, the application of the Principles in the context of treaty-based disputes is not equally straightforward. This is because the Principles were primarily destined to regulate transnational contracts subjected to a-national rules instead of the domestic law of the host state out of fear that the latter would be subsequently amended to the detriment of the interests and

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[373] ICC International Court of Arbitration (First Partial Award) 7110, June 1995, Retrieved from: http://www.unilex.info/case.cfm?id=713. See also Hamida, W.B. (2012), Les Principes d'UNIDROIT et l'arbitrage transnational: L'expansion des principes d'UNIDROIT aux arbitrages opposant des Etats ou des organisations internationales a des personnes privées, Journal du droit international (Clunet), 4 (12): 1, at 4

[374] *Ministry of Defense and Support for the Armed Forces of the Islamic Republic of Iran v. Cubic Defense Systems Inc:* Rev. Dr. Uniforme 1999, p. 796.

[375] *United States District Court, S.D. California, Ministry of Defense and Support for the Armed Forces of the Islamic Republic of Iran v. Cubic Defense Systems, Inc.* – 29 Fed. Suppl. 2nd, 1168: Rev. Dr. Uniforme 1999, p. 1016.

expectations of the foreign investor - a fear often called "alea de la souverainete" - [376] and not issues arising from the alleged violation of an investment-treaty rule. However, a recent trend in the case law of investment-treaty tribunals shows that the role of the UNIDROIT Principles as general principles of law relevant for the adjudication of treaty disputes, is increasing.

There are three primary modes under which the UNIDROIT Principles are relevant in the context of investor-state arbitration. The first one is their use as the "applicable law", or (more correctly) "rules of law" chosen by the parties, either expressly or implicitly - for example, through reference to general principles of law, the *lex mercatoria*, or international trade usages.[377] Albeit possible, to date, there are no international investment agreements including an explicit choice-of-law provision referring to the UNIDROIT Principles.[378] Thus, this mode of application remains more relevant for contract-based and not treaty-based disputes.

Nevertheless, the ICSID Convention leaves clearly open the possibility for the application of the Principles in the context of treaty-based disputes. Article 42 reads that the Parties have the autonomy to choose any rules they wish to apply in the resolution of their disputes, and not only a domestic legal system. An example of a "negative choice" of the Principles through the exclusion of a specific national law was the case of *Lemire v. Ukraine* involving the alleged violation of a settlement agreement embodied in an earlier ICSID Additional Facility award.[379]

In its interpretation of the settlement agreement the ICSID tribunal relied heavily on the Principles, particularly with regard to good faith and fair dealing, as well as the principle of estoppel/venire contra factum proprium,[380] reasoning that the claimant had lost his right to invoke a specific contractual breach which he had appeared to condone earlier.[381] The tribunal concluded that the UNIDROIT Principles were a manifestation of transnational law and, as such, included "within the rules of international law." [382]

[376] Bernardini, P. (2014), UNIDROIT Principles and international investment arbitration, Revue du Droit Uniforme, 19 (4): 561, at 563.
[377] Reinisch, A. (2014), *The relevance of the UNIDROIT Principles of International Commercial Contracts in international investment arbitration*, Uniform Law Review, 19 (4): 609, at 610.
[378] See Cordero-Moss, G. & Behn, D. *supra* note 320, at 562.
[379] *Joseph Lemire v Ukraine*, Award, ICSID Case ARB/06/18, 28 March 2011 (*Lemire II*). The *Lemire* case serves also as an example of the value of mediation - analyzed in the previous section - and of a negotiated settlement of an investor-state dispute. *Lemire I* resulted in a settlement agreement between the parties.
[380] Article 1.8 of the UNIDROIT Principles: "A party cannot act inconsistently with an understanding it has caused the other party to have and upon which that other party reasonably has acted in reliance to its detriment."
[381] See Reinisch, A., *supra* note 340, at 612.
[382] See the *Lemire* award, *supra* note, paras 109-11.

The principle of *estoppel*, as crystallized in the UNIDROIT Principles and used in *Lemire II*, can also be relevant when assessing the investor's conduct [383] vis-à-vis renegotiations of the investment contract in question. For example, if an investor had accepted such renegotiations in the past as common practice (as expected in the case of relational contracts), and even more in the case that she had initiated one or more renegotiations herself, protesting only to the last renegotiation giving rise to the treaty dispute would go against the *estoppel* principle. Such an evaluation, though, requires a shift in the reasoning of arbitral tribunals from viewing the contractual matters as detached from the treaty claims to examining the underlying contracts as relational contracts and taking into account their evolution when judging the alleged breach of a treaty standard.

More importantly, in the absence of a choice of law by the Parties (which is the usual case with investment treaties), the tribunal has to apply (according to the second paragraph of Article 42) the law of the host state and the relevant principles of international law. *Goldman* has argued that "international law" in this context does not mean at all public international law,[384] but refers to the general principles of international law constituting the *lex mercatoria*.[385] Although the World Bank report on the ICSID Convention takes a broader view of "international law" including all the sources of Article 38 of the ICJ Statute,[386] the UNIDROIT Principles still fall under its scope as general principles of law recognized by the civilized nations.[387] This interpretation has also been confirmed by the former Secretary General of ICSID, *A. Parra*.[388] The UNIDROIT Principles thus serve as yet another connecting factor between the contract and the overarching treaty showing the incompleteness of public international law to address alone the complexities of transnational contractual relationships between states and foreign investors.

As *Sornarajah* has observed, "no one has identified the existence in international law of such a body of exhaustive principles relating to the formation of foreign investment contracts, their operation, termination, breach, and finally the remedies to be proved for their breach in any coherent fashion. There is, of course, the possibility of the argument that these principles do exist in international law but that they have not been discovered and that the arbitrator can discover them when necessary. It is the Aladdin's cave argument. The argument that the judge has the secret formula to open the cave in which

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[383] On the behavioral aspect of general principles of law, see Berger, K.P., *supra* note 291, at 153-154.
[384] Goldman, B. (1979), *Deuxieme séance pleniere de la Commission de l'IDI*, 58: 54.
[385] Goldman B., (1979), *La lex mercatoria dans les contrats et les arbitrages internationaux: Realites et perspectives*, JDI: 485.
[386] Administrateurs de la Banque Mondiale, Rapport sur la Convention de Washington, para 40, Retrieved from: https://icsid.worldbank.org/fr/Pages/icsiddocs/REPORT-OF-THE-EXECUTIVE-DIRECTORS-ON-THE-ICSID-CONVENTION.aspx
[387] Article 38 (1) (c) of the ICJ Statute.
[388] See Hamida, W.B. (2012), *supra* note , at 11

is stored the relevant principles and select the principles which are relevant to new situations." [389] On the other hand, as *Hamida* notes, even fervent supporters of the internationalization of state contracts, such as *Weil*, admit to this lacuna of the regulation of transnational state contracts in international law.[390]

Another way in which the UNIDROIT Principles have become relevant in investor-state arbitration is their use as arguments supporting and legitimizing a specific "interpretation" of the applicable law.[391] For example, in *African Holding Company v. Democratic Republic of the Congo*, the tribunal resorted to the UNIDROIT Principles to find that under Congolese law a contract did not have to be in writing to be valid. Similarly, it held - again by reference to the Principles - that the conduct of the parties was sufficient evidence of the existence of a construction contract. The relevance of the conduct of the parties for determining the terms of their agreement corroborates the argument made herein, on the relational nature of complex, long-term investment contracts, as opposed to an exclusive, classical-contract-theory, focused on the four corners of the parties' agreement.

Another award wherein the Principles were heavily relied upon to impose the second highest damages in the history of investment arbitration was the *Al Kharafi v. Libya* case.[392] The tribunal exercised broad discretion, relying on Article 7.4.3 of the UNIDROIT Principles, in calculating the amount of damages awarded to the investor. It is apposite to observe that, in the same way that arbitrators can use the discretion of the UNIDROIT Principles to decide on the amount of damages, they can (and shall) also use the discretion by other UNIDROIT provisions, namely on hardship, to decide the legal consequences of renegotiation for a state's liability to award damages in the first place.

In a similar vein, the decisions on *AIG Capital v. Kazakhstan* and *Gemplus & Talsud v. Mexico* were based extensively on the UNIDROIT Principles to determine compensation. The latter went as far in recognizing the authoritative status of the UNIDROIT provisions as general principles of law, as to find it unnecessary to engage in a comparative analysis of the different national legal systems. The tribunal argued instead that the broad

[389] Sornarajah, M. (1997), *Power and justice in foreign investment arbitration*, Journal of International Arbitration, 14 (3): 103, at 113.
[390] Weil, P. (1981) *Droit international et contrats d'Etat*, in: *Le droit international, unité et diversité : mélanges offerts à Paul Reuter*, Paris: A. Pedone, at 568.
[391] See Cordero-Moss, G. & Behn, D., *supra* note 320, at 27-35, citing several awards in investment case law - *inter alia*, *AIG v. Kazakh*stan, *Sax v. City of Saint Petersburg*, and *Suez v. Argentina* - wherein the UNIDROIT Principles were deployed as generally recognized principles corroborating a particular interpretation of the applicable domestic law.
[392] *Mohamed Abdulmohsen Al-Kharafi & Sons Co v. Libya and others*,Final Arbitral Award, 22 March 2013.

restatement of the provisions in the body of the UNIDROIT Principles was sufficient evidence of their recognition as general principles of law.[393]

Even more radical in this regard was the decision in the *Petrobart* case, based on the Energy Charter Treaty, wherein Article 7.4.9 of the UNIDROIT Principles was directly applied as a rule of international law, without explaining why this provision constitutes a general principle of law and thus part of the applicable international law. A similar approach was taken in *Eureko v. Poland* - a case based on the Netherlands-Poland BIT - wherein the tribunal resorted to the UNIDROIT Principles as proof of the existence of a general principle without further examination of its status under the various national legal systems.[394]

This thesis takes stock of the aforementioned case law and emerging trends in investor-state arbitration recognizing the relevance of the UNIDROIT Principles as general principles of international law. However, it takes a more elaborate approach to identifying the status of the individual provisions of the UNIDROIT Principles as general principles of international law, namely those relating to the renegotiation of long-term state contracts. The following section examines the legal effects of the UNIDROIT provisions on hardship, any relevant arbitral awards making use of the hardship principle, as well as its potential emerging status as a general principle of international law.

d) *The Renegotiation of State Contracts and the UNIDROIT Principles on Hardship*

i) *Force Majeure* and Hardship under the UNIDROIT Principles

Having established the relevance of the UNIDROIT Principles for state contracts and their applicability in investment-treaty cases, this section turns to the relevance of the UNIDROIT provisions on hardship for investor-state disputes arising from the renegotiation of infrastructure contracts.

Both *force majeure* and hardship are covered by the UNIDROIT Principles and are often invoked in international disputes simultaneously. Nevertheless, there are several differences between the two defenses, both regarding the extent of their recognition as general principles of international law and their legal effects. The emphasis of the present section is on hardship; however, given the commonalities between the two principles, it is apposite to make a brief reference to *force majeure* first. Given the fact that *force*

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[393] *Gemplus & Talsud v. Mexico*, ICSID Case No. ARB (AF)/04/03 and ARB (AF)/04/04, Award, 16 June 2010. See also Reinisch, A., *supra* note 340, at 616.

[394] *Eureko v. Poland*, *Ad hoc* UNCITRAL Arbitration, Partial Award, 19 August 2005, paras 176-180.

majeure is more often invoked in arbitration than hardship, some of the lessons learned from the former can also apply when the latter is invoked.[395]

Unlike hardship, which is a defense allowing for the renegotiation of a contract to restore its financial equilibrium, *force majeure* is an excuse from performance. It essentially shares with hardship the preconditions required for its application, namely an impediment beyond the obligor's sphere of control and the non-assumption of the relevant risk by the obligor. The key issue herein is the allocation of risk between the parties and the narrow or broad interpretation of such allocation.

Even the "foreseeability" of the impediment is to be examined in the context of risk allocation. According to the impracticability test under American law, excuse is not necessarily precluded, if the contingency that occurred was foreseeable. Instead, foreseeability is at best one factor to be considered in deciding how likely the occurrence of the event was, and "whether its occurrence was of such reasonable likelihood that the obligor should not only foresee its occurrence but also guard against it." [396]

Force majeure is a general principle of law recognized in most representative legal systems. Although, as aforementioned, the application of a general principle in international law presupposes its adaptation and a potentially different content compared with its various national expressions, the *force majeure* defense exists in comparable ways in several domestic laws. Civil law systems recognize the doctrine of impossibility of performance. Even in cases where it is disputed whether "economic impossibility" or "commercial impracticability" fall under the category of *force majeure*, they are both addressed under the doctrine of *clausula rebus sic stantibus*.[397]

In English common law, *force majeure* is covered by the doctrine of frustration of contract, as established in *Taylor v. Caldwell* and refined in *Davis Contractors Ltd. V. Fareham U.D.C*. The frustration rule shares with the defense of hardship the requirement for a fundamental change of the circumstances under which the contract was signed. However, unlike hardship, the legal effects under English law are more radical, as they cover only cases where performance is absolutely impossible and only allow for the non-performance of the contract, and not its adaptation to the changed circumstances. On the contrary, American law accepts the concept of "commercial impracticability" resembling in this regard most civil-law systems.

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[395] According to the Kluwer Arbitration database, there are more than 200 awards involving *force majeure* while only a few more than 50 awards dealing with hardship.
[396] See *supra* Brunner, C. (2009), at 121-122, 156-157. See also *United States v. Winstar Corp.,* 518 U.S. 839, 1 July 1996.
[397] Id., at 77-78.

ii) The UNIDROIT provisions on hardship in investor-state dispute settlement

(A) Hardship as a General Principle of Law

Hardship is a defense closely related to *force majeure* but producing distinct legal consequences. The UNIDROIT Principles on hardship are the most relevant provisions for the purposes of the renegotiation of state contracts and the adjudication of the ensuing arbitral disputes. The frequent invocation of hardship in the disputes that ensued from Argentina's severe economic crisis proves the relevance of the defense in investor-state dispute settlement.

The application of the principle, though, without a developed legal analysis and by conflating it with other defenses, such as the defense of necessity under public international law, creates confusion about the appropriate applicable law, and is to the detriment of both legal predictability and the fair adjudication of investor-state disputes. This section aims to clarify the conditions for invoking hardship under the UNIDROIT Principles, its status as a general principle of international law, and the essential legal consequences that the defense produces.

Unforeseen supervening events, such as economic breakdowns or political upheavals, can change fundamentally the circumstances under which the parties had allocated their risks and calculated their costs and benefits under their contract, and can thus alter fundamentally the equilibrium of their contract. The question arising in this context is which party should bear the risk of such change and to which extent.

As analyzed previously, the dilemma herein is between the principle of *pacta sunt servanda* and the equally fundamental principle of good faith. Among the three primary ways in which the conflicting principles can be weighed against each other - strict adherence to *pacta sunt servanda*; complete exoneration of the distressed party; and the apportionment of the supervening economic risk through adaptation of the contract and restoration of its equilibrium - the UNIDROIT defense of hardship opts for the last, middle-ground solution.[398]

Both civil and common-law systems recognize the defense of hardship in case of a fundamental change in circumstances. In civil law, the doctrine of *clausula rebus sic stantibus* allows for the adjustment (or even the avoidance) of the contract, when its

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[398] Id., at 391. See also Jones, G. & Schlechtreim, P. (1999), *Contracts in General*, International Encyclopaedia of Comparative Law, Vol. VII, at 135.

performance becomes excessively onerous[399] for the distressed party. The principle is specifically prescribed in many Civil Codes - *inter alia*, the Argentine, the Brazilian, the Dutch, the German,[400] the Italian, the Greek, and the Portuguese - or recognized by case law.

On the other hand, U.S. law recognizes the principle of "commercial impracticability", distinguishing, though, between a simply bad bargain (the risks of which should be borne by the distressed party) and a fundamental alteration of the contractual equilibrium (which is indeed covered by the defense of hardship). While, on the contrary, English law appears to be less receptive to hardship allowing relief only in case of impossibility, in effect the doctrine of frustration of purpose covers also cases of impracticability.

As developed in English case law, the two doctrines, frustration of purpose and impracticability due to hardship, often overlap. However, the beneficiary of the defense of hardship is, in principle, not the distressed party but its counterparty, that is, the recipient of the performance affected by the supervening hardship.[401] This approach resembles the French doctrine of imprévision, which is designed primarily to protect concessionaires from a change resulting from a "fait du prince", rather than the state from a fundamental change in circumstances. The doctrine of imprévision is further examined below.

Arbitral case law has also accepted hardship as a general principle of law. The Iran-United States tribunal explicitly recognized hardship (or *clausula rebus sic stantibus*) as a general principle of law sanctioned also in Article 62 of the Vienna Convention on the Law of Treaties of 1969.[402] ICC case No. 7365 also applied the defense of hardship by referring explicitly to the relevant UNIDROIT provisions.[403] Similarly, ICC No. 1512

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[399] "*Eccessiva onerosità sopravenuta"*, according to the Italian Civil Code.

[400] The German theory of "*Wegfall der Geschäftsgrundlage"* is alleged to have been influential in the formation of the definition of hardship included in the UNIDROIT provisions.

[401] Treitel (2011), *The Law of Contract*, Sweet & Maxwell, at 284.

[402] See Iran-US Claims Tribunal, Questech Inc. v. Iran, 9 IRAN-U.S. C.T.R. 9, at 107 et seq., at 122-123: "The concept of changed circumstances, also referred to as *rebus sic stantibus*, has in its basic form been incorporated into so many legal systems that it may be regarded as a general principle of law; it has also found a widely recognized expression in Article 62 of the Vienna Convention on the Law of Treaties."

[403] ICC International Court of Arbitration, Paris 7365/FMS, Arbitral Award, 05.05.1997, http://www.unilex.info/case.cfm?id=653: " […] in finding that, as a result of the chaotic events preceding and following the Islamic Revolution in February 1979, each party was entitled to unilaterally request termination of the contracts or adaptation of their terms, the Arbitral Tribunal expressly referred to Article 6.2.3(4) of the UNIDROIT Principles, pointing out that "[...] from the covenant of good faith and fair dealing which is implied in each contract follows that in a case in which the circumstances to a contract undergo [...] fundamental changes in an unforeseeable way, a party is precluded from invoking the binding effect of the contract [...] In such restrictive and narrow form this concept [of hardship or clausula rebus sic stantibus] has been incorporated into so many legal systems that it is widely regarded as a general principle of law. As such, it would be applicable in the instant arbitration even if it did not form part of the Iranian law".

recognized hardship, but Professor *Lalive* pointed to its narrow and strict interpretation in order to preserve the sanctity of contracts.[404]

(B) The conditions and legal effects of hardship

The duty to renegotiate in the event of hardship has its legal basis on the general principles of good faith and fair dealing, which are particularly relevant in the case of complex, long-term contracts.[405] Hardship occurs when there is a fundamental alteration of the equilibrium of the contract due to contingencies beyond the control and sphere of risk of the obligor. Whether an alteration qualifies as "fundamental" is a factual matter depending on the circumstances of the particular case.

Indeed, the 50% threshold test originally set in the Comment on the 1994 edition of the UNIDROIT Principles was deleted from their later, 2004 version. The omission from the updated Principles of the threshold of 50% for marking a "fundamental" change in the value of performance leaves more discretion to the courts and tribunals to judge when a change is "fundamental". Arbitrators are thus expected to engage in an exercise of carefully balancing the principle of sanctity of contracts with the equally important principles of good faith, fair dealing, and cooperation.

Another condition central to invoking the defense of hardship is the non-assumption of the materialized risk by the distressed party. Absent the explicit assumption of the risk in the contract, it must be determined whether the event of hardship was reasonably foreseeable. Despite the perception that all catastrophic events are in theory foreseeable, hard-and-fast rules are difficult to apply, because foreseeability is a question of degree: "mild" and "acute" expressions of the event have to be distinguished from each other.

The most relevant aspect of hardship for the purposes of the present thesis is its principal legal consequence. Should the conditions of the defense be fulfilled, the distressed party has "the right to request the renegotiation" of the contractual relationship. The central question arising in this context refers to the content and legal effects of the duty to renegotiate. With regard to the content, the party confronted with the request to renegotiate has an obligation of conduct and not of result, meaning that it has to deploy its best efforts to assess the request in good faith, without this precluding the adversarial

[404] ICC Award No. 1512, YCA 1976, at 128 et seq. See also Brunner, *supra* note, at 417.
[405] See, for example, Article 5.1.3 of the UNIDROIT Principles on the duty to cooperate.

character of the renegotiation process that may ultimately lead to litigation (or arbitration).[406]

More significant in the context of ISDS are the legal consequences of a renegotiation request. Refusal of a party to conduct a meaningful renegotiation process would seriously impact the admissibility of its arbitral claim, as almost all investment treaties contain multi-tier dispute resolution clauses as jurisdictional conditions precedent to arbitration, as well as mandatory cooling-off periods.[407]

Several investment tribunals have taken seriously the treaty provisions on good-faith (re) negotiations for establishing their jurisdiction. For example, the tribunal in *Tulip Real Estate v. Turkey* found that the requirement to seek negotiations is not to be "watered down to a mere statement of aspiration", but is instead an "essential element of Turkey's prospective consent" to international arbitration and thus "a pre-condition to the jurisdiction of this Tribunal." [408] Similar was the approach in *Murphy v. Ecuador*, where the tribunal declined jurisdiction on the basis of the failure of the claimant to comply with the cooling-off period, which is a fundamental requirement for the submission of an arbitration request under the ICSID rules.[409]

The second legal consequence of the request for renegotiation, pursuant to the UNIDROIT provisions on hardship, is the right of the distressed party to raise the issue of the adaptation of the contractual relationship with a judge or arbitrator, in case the bilateral renegotiations fail. Translating this consequence in the field of international investment law, the forum the most appropriate to pursue such adaptation, in order to avoid the escalation of the collapse of the contractual relationship to an investment-treaty dispute, is international mediation.

The last chapter elaborates on the proposal for the reform of the ISDS system to embrace mediation as a procedural mechanism for the renegotiation of investor-state contracts. The following section focuses, on the other hand, on the substantive consequences that renegotiation due to hardship has produced in investor-state disputes and examines the

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[406] See Brunner, C., *supra* note 89, at 319, 484.

[407] OECD, Investor-State Dispute Settlement, A Scoping Paper for the Investment Policy Community, OECD Working Papers on International Investment 2012/2013, Retrieved from: http://www.oecd.org/investment/investment-policy/WP-2012_3.pdf, at 15. See also Vlavianos, G. & Pappas, V. (2017), *Multi-Tier Dispute Resolution Clauses as Jurisdictional Conditions Precedent to Arbitration*, Retrieved from: http://globalarbitrationreview.com/chapter/1142626/multi-tier-dispute-resolution-clauses-as-jurisdictional-conditions-precedent-to-arbitration.

[408] *Tulip Real Estate and Development Netherlands B.V. v. Republic of Turkey*, Decision on Bifurcated Jurisdictional Issue [Art 41 ICSID], ICSID Case No. ARB/11/28, 5 March 2013, para. 72. See also UNCTAD (2014), *Recent Developments in Investor-State Dispute Settlement* (ISDS), Retrieved from: http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d3_en.pdf, at 11.

[409] *Murphy Exploration and Production Company International v. Republic of Ecuador,* Award on Jurisdiction, ICSID case No. ARB/08/4, 15 December 2010, para. 149.

case law that has made use of the hardship defense under the relevant UNIDROIT Principles.

(C) The case law on hardship in investment-treaty arbitration

The awards ensuing from the Argentine economic crisis

The principle of hardship has been quoted in numerous investment awards, either as linked to the defense of necessity or (less often) as a stand-alone defense. This section examines the relevant case law and its implications for the legal status of hardship in investor-state dispute settlement, as well as its potential future development and policy consequences for the adjudication of disputes arising from the renegotiation of state contracts. The emphasis herein is on the disputes that ensued from the renegotiation of concession contracts in Argentina due to the country's economic crisis.

In *Total v. Argentina*, hardship was described as a mere matter of fact and part of the socio-political context within which the government passed the Emergency Law abolishing the convertibility regime.[410] On the other hand, the legal (and not merely factual) status of hardship was recognized in *Enron v. Argentina*, wherein the tribunal precluded the invocation of hardship as an escape route from the investment treaty and the state's international obligations for the protection of foreign investors.[411] In the same vein was the decision in *Sempra v. Argentina*.[412]

Hardship was also cited on various occasions in *Continental Casualty v. Argentina*. First, it was described in the factual background of the case as a result of the economic crisis the country faced, and it was also mentioned as one of the events that ensued from the enactment of the *Corralito*. Apart from this factual description, the tribunal considered hardship also as one of the elements to determine whether there was a public emergency justifying the invocation of the BIT clause for the protection of the state's essential security interests (the Non-Precluded-Measures clause).[413]

Another award dealing with the Argentine economic crisis, *CMS v. Argentina*, connected hardship with the core issue of the allocation of risks between the host state and the

[410] See *Total v. Argentina*, *supra* note 153 Decision on Liability, ICSID Case No. ARB/04/1, 27 December 2010, para. 79. This factual approach might be due to the common-law background of some arbitrators that understand hardship only as a fact. See http://www.austlii.edu.au/nz/journals/VUWLawRw/2008/39.pdf note 12.
[411] *Enron v. Argentina*, ICSID No. ARB/01/3, Award, 22 May 2007, para. 331.
[412] *Sempra v. Argentina*, ICSID Case No. ARB/02/16, Award, 28 September 2007, para. 373.
[413] See *Continental Casualty v. Argentina, supra* note 283 Award, ICSID Case No. ARB/03/9, 5 September 2008, paras. 108, 126, 180.

foreign investor. The tribunal pointed out that the arbitral award is not an insurance policy against business risk, meaning that foreign investors should account for the political-economy environment in which they operate. Consequently, any burden caused by hardship should be shared reasonably between the parties.[414] This approach is aligned with the position of this thesis on the (underestimated, yet indispensable) value of renegotiation and mediation to strike a balanced solution in the wake of changed circumstances.

However, the tribunal in the *CMS* award conflated the defense of hardship and its legal remedy of renegotiation, as crystallized in the UNIDROIT Principles, with the allocation of risk through contractual mechanisms, namely tariff review clauses. Tariff review clauses do not preclude the existence of hardship, though, which is a legal issue to be addressed separately. For one part, the arbitrators have to examine not only "whether" but also "how much" of the materialized risk the distressed party had possibly assumed.[415] Moreover, the tribunal should assess carefully who in effect assumed the exact risk in question. Risk assumption or non-assumption can be express (established in the contract or statutory provisions) or implied, taking into account all relevant circumstances.

Particularly in the field of currency depreciation, there are significant variations in the foreseeability and assumption of the ensuing risks. A slow currency depreciation stipulated in the contract does not mean that a massive devaluation of the currency resulting from an unprecedented socio-economic collapse was equally foreseeable.[416] Moreover, the foreseeability of a contingency should not be confused with the issue of risk allocation. As Argentina argued, the intently inflated tariffs entailed the assumption of the devaluation risk by the state, thus recognizing the element of country risk.

The fact that Argentina assumed such risk, thus allowing for *higher tariffs* during the normal course of the concession, did not mean that it also foresaw the subsequent, major collapse of its economy and assumed all the ensuing risks. Such an assumption would transform a limited and circumscribed assumption of risk to a strict-liability insurance policy against all possible contingencies. However, this is precisely the position that the tribunal took, thus distorting a specific risk allocation with the foreseeability of all - even remotely connected - eventualities.[417]

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[414] *CMS v. Argentina*, Award, ICSID Case No. ARB/01/8, 12 May 2005, para. 248. On the contrary, see para. 347 with regard to the *Socobelge* case, wherein the obligations under a contract were upheld despite the financial hardship that Greece confronted in the 1930s. See *Societé Commerciale de Belgique*, 1939 PCIJ Series A/B, 160-90.

[415] See *supra* Brunner, C., at 393, and *United States v. Wegematic Corp.*, (1966) 2nd Circuit 674, 676.

[416] McKendrick, E. (2008), *Hardship*, in: Contract Law, Text, Cases, and Materials, Oxford University Press, at 721

[417] See paras 184 and 225 of the *CMS* award.

Another aspect of the allocation of the currency risk to be taken into account, is whether a specific risk assumption was stipulated in the original contract, or on the contrary, was itself the result of a bilateral renegotiation between the parties after the investor secured the concession. Such a bilateral-dependency condition is relevant for the application of other UNIDROIT provisions, namely those on gross disparity or corruption, in combination with the provisions on hardship and risk allocation. For example, the denomination of tariffs in US dollars (instead of pesos) in the case of *Aguas Argentinas* was the product of such a bilateral renegotiation.[418]

Last but not least, the potentially speculative nature of a transaction (for example, the fact that CMS's investments were highly leveraged) should also be taken into account. Concluding a speculative contract usually leads to a higher level of risk assumption. A higher profit margin may indicate that the supplier assumed a greater risk with regard to future contingencies.[419]

As a final remark, the relevance of the applicable law for evaluating the aforementioned matters is central. It is not clear why, in its evaluation of hardship, the *CMS* tribunal took recourse to the French doctrine of *imprévision* and particularly the decision in *Gaz de Bordeaux*, instead of applying the UNIDROIT Principles on hardship. While not explaining why recourse to French law was necessary, the tribunal held that it did not need to look into general principles of law to find an answer on how the contract in this case could be adjusted to new economic realities, on the alleged basis that the pertinent mechanisms were embodied in the law and the License itself.

The defense of hardship under the UNIDROIT Principles should also not be confused with the defense of necessity under customary international law[420] or, alternatively, the Non-Precluded-Measures clause included in several BITs.[421] Whereas the latter aim at precluding liability or, alternatively, wrongfulness, in case of a "grave and imminent peril" or threat to "essential security interests", the purpose of the hardship defense is to place the parties on an equal footing vis-à-vis their right to renegotiate their contractual relationship in the face of materially changed circumstances. Despite the fact that these

[418] See Wells, L. (2010), *supra* note 84, at 345-346.
[419] See Brunner, C. *supra* note 89, at 433.
[420] See Article 25 of the ILC Articles on State Responsibility.
[421] As established in the Annulment Award in the *CMS* case, the state of necessity under customary international law is distinct from the non-precluded measures clause. The distinction of the two instruments is beyond the scope of the present section, which focuses on the separate defence of hardship and its own legal consequences, particularly the renegotiation of the contractual relationship.

legal instruments have been conflated in several arbitral awards,[422] hardship is a stand-alone defense with distinct legal consequences.

For one part, the conditions of hardship are more lenient compared to the rigid and strict prerequisites of the necessity defense. The invocation of hardship does not require the existence of a "grave and imminent peril" but only a fundamental alteration of the contractual equilibrium. Moreover, the consequence of hardship is not the preclusion of the wrongfulness of the disputed act - as in the case of necessity - but the legality and legitimacy of the renegotiation request and the resulting renegotiation process. This (underestimated) legal consequence has important implications for the resolution of the relevant disputes, both in terms of procedural justice and for the adjudication of the substantive investment-treaty standards.

The principle of hardship in international law is also not to be conflated with the doctrine of *imprévision* under French law. As aforementioned, the crystallization of a general principle of law, as ensues from a comparative analysis of its equivalents in national systems, does not mean that the different doctrines compared are identical.[423] *Imprévision* - a doctrine primarily applicable to administrative contracts - has its origins and *raison d'être* in the protection of the private contractor from a *fait du prince*. It aims to reassure private investors running public services that, if they face hardship, their contract will be adjusted to the new circumstances.[424]

In other words, in case of an unforeseen, adverse change in the equilibrium of the contract, the concessionaire can request the administration to grant an additional financial contribution, that is, to indemnify the contractor for the additional burden that the financial burden entails. Although in theory the defense is equally available to the state, the doctrine has not been developed with a view to relieving the public sector from performing its obligations, when it faces hardship.[425] Also, in case that the state modifies

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[422] See *inter alia Continental v. Argentina*, *supra* note, paras 102, 108, wherein hardship is merely considered as one of the factual elements of the defence of necessity, and *Sempra v. Argentina*, *supra* note paras 373 et seq., which include economic hardship and emergency within the scope of the non-precluded measures clause. On "conflation" see also Kurtz, J. (2011), *Delineating Primary and Secondary Rules on Necessity at International Law*, in: Broude, T., Shany, Y. (Eds), *Multi-Sourced Equivalent Norms in International Law*, Oxford: Hart Publishing, at 248-251.

[423] See Brunner, C. *supra* note 89, at 403-406. See also Tallon, D. (2004), *Hardship*, in: Hartkamp et al. (Eds), *Towards a European Civil Code*, Springer, at 500-501.

[424] Peter, W. (1995) *supra* note 180 *Arbitration and Renegotiation of International Investment Agreements*, Kluwer Law International, at 190

[425] Id., at 198. See also Geiger, R. (1974), *The Unilateral Change of Economic Development Agreements*, Cambridge University Press, at 99: "It is true that the theory of imprévision has been primarily conceived for the benefits of the private contractor." See also the comment of the French Ministry of Economy at: http://www.economie.gouv.fr/files/directions_services/daj/marches_publics/conseil_acheteurs/questions-reponses/execution-marches/qr-4-3-imprevision.pdf

the contract to its benefit, such unilateral modification does not absolve it from its liability to grant compensation to the private party.[426]

In a nutshell, the French doctrine of *imprévision* does not overlap with the UNIDROIT principle of hardship. Among the differences between the two instruments is the inequality of arms between the contracting parties, in the case of *imprévision*, which primarily aims at the protection of the investors from a change in circumstances and a possible regime change from the part of the state.[427] On the contrary, hardship is a defense equally available to both contracting parties. Moreover, (by definition) the focus with *imprévision* is on the foreseeability of the event, while the emphasis with hardship is on the burden weighing excessively on one of the parties.[428] Another important difference between the two doctrines is that hardship, as all general principles of law, needs to be adapted in order to apply in the international plane.[429] The following section refers to the

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[426] Id., at 97: "The mutability of administrative contracts means nothing else than a change in remedies. The contactor cannot oppose to adjustments made in the interest of the public service any claims for strict performance of the contract. His remedy is to seek monetary compensation for the additional burdens or unexpected losses, which result from these adjustments. As to the measure of the indemnity, we have to distinguish two theories: the fait du prince and l'imprevision."

[427] See the seminal decision on *Gaz de Bordeaux*; Conseil d'Etat, 30 Mars 1916, 59928, Recueil Lebon, "*En principe, le contrat de concession règle, d'une façon définitive, jusqu'à son expiration les obligations respectives du concessionnaire et du concédant, le concessionnaire est tenu d'exécuter le service prévu dans les conditions précisées au traité et se trouve rémunéré par la perception sur les usagers des taxes qui y sont stipulées et la variation du prix des matières premières […] qui peut, suivant le cas, être favorable ou défavorable au concessionnaire et demeure à ses risques et périls, chaque partie étant réputée avoir tenu compte de cet aléa dans les calculs et prévisions qu'elle a faits avant de s'engager. Toutefois, la hausse survenue au cours de la guerre de 1914, dans le prix du charbon, […] a atteint une proportion telle que non seulement elle a un caractère exceptionnel dans le sens habituellement donné à ce terme, mais qu'elle entraîne dans le coût de la fabrication du gaz une augmentation qui, dans une mesure déjouant tous les calculs, dépasse certainement les limites extrêmes des majorations ayant pu être envisagées par les parties lors de la passation du contrat de concession. En conséquence, l'économie du contrat se trouve bouleversée et le concessionnaire de l'éclairage au gaz d'une ville est fondé à soutenir qu'il ne peut être tenu d'assurer aux seules conditions prévues à l'origine le fonctionnement du service, tant que durera la situation anormale ci-dessus indiquée. Le concessionnaire est tenu d'assurer le service concédé, avec tous ses moyens de production, mais le concédant doit lui venir en aide. Le concessionnaire ne peut d'ailleurs prétendre que le marché ayant prévu un certain prix pour la tonne de charbon, qui aurait correspondu au prix maximum du gaz fixé au contrat, toute augmentation du prix du charbon au delà de celui indiqué au marché doit être mise exclusivement à la charge du concédant ; elle doit supporter au cours de cette période transitoire, résultant des circonstances indiquées, la part des conséquences onéreuses de la situation de force majeure ci-dessus rappelée, que l'interprétation raisonnable du contrat permet de mettre à sa charge. […]Le concessionnaire d'un service de l'éclairage au gaz d'une ville soutenant que le concédant doit supporter l'aggravation de charges résultant de la hausse du prix du charbon, il s'agit là d'une difficulté relative à l'exécution du contrat de concession […]*" Emphasis added.

[428] Working Group for the Preparation of Principles for International Commercial Contracts (1992), at 1: "Maskow commented that […] if one used the term "hardship" focus was on the burden which was on one of the parties; if one took the term "imprevision" then focus was on the possibility to foresee the event."

[429] See, for example, *El Paso v. Argentine Republic*, *supra* note para. 622: "Volumes have been written on the subject of "general principles". […] The mainstream view seems to be, however, that "general principles" are rules largely applied in *foro domestic* […] provided that, *after adaptation*, they are suitable for application on the level of public international law". Emphasis added. See also Mosler, H. (1995), *General Principles of Law*, in: R. Bernhardt (Eds.), *Encyclopedia of Public International Law*, Vol. II (E-I)

arbitral awards dealing specifically with the UNIDROIT Principles on hardship, namely the decisions in *El Paso v. Argentina*, and *Suez v. Argentina*.

The awards referring to the UNIDROIT Principles on hardship

Two decisions making explicit reference to the UNIDROIT Principles on hardship are worth examining because of their originality in deploying the Principles to address investment-treaty claims. The award in *El Paso v. Argentina* resorts only to a selective application of the relevant UNIDROIT provisions, while the dissenting opinion of *Pedro Nikken* in the *Suez* case illustrates clearly the argument of the present thesis, that is, the legality of the renegotiation process itself and the need to regulate it in order to achieve a fair balance between the interests of the disputing parties in the face of materially changed circumstances.

What makes the *El Paso* case original is the fact that, while recognizing the separability of contract claims from treaty claims, it applied the UNIDROIT Principles - primarily destined to regulate contractual matters - to the substance of the claims arising under the BIT between Argentina and the U.S, thus using them to supplement public international law. By deploying the Principles to interpret Article XI of the treaty (which stipulates the Non-Precluded Measures clause) the tribunal departed from previous awards regarding the relationship between the non-precluded measures clause and the necessity defense under customary international law. Instead of conflating the two legal rules, it considered Article XI as *lex specialis* to the defense of necessity, and used the latter to interpret the former.

More specifically, the tribunal interpreted Article XI of the BIT using Article 31(3) (c) of the Vienna Convention of the Law of Treaties. According to the latter, the interpretation of a treaty rule should take into account any relevant rules of international law applicable in the relations between the Parties. The tribunal considered Article 25 of the ILC Articles on the Responsibility of States for Internationally Wrongful Acts to qualify as such a relevant rule of international law in that case. The emphasis was on the specific condition of Article 25 that the state has not contributed to the emergency, in order for the necessity defense to be effective. The arbitrators used this general rule of non-contribution to interpret the invocation of the essential-interest clause in Article XI of the BIT.

The novelty of the reasoning in *El Paso* is that the tribunal went a step further in affirming the status of the "non-contribution" rule as a general principle of law in the sense of Article 38(1)(c) of the ICJ statute. In addition to referring to previous investment

awards (even those it disagreed with) the tribunal took a broader view of the sources of international law relevant for the interpretation and the implementation of the investment treaty in question, and ultimately of the effective resolution of the dispute.

The distinctive feature of *El Paso* is the fact that the tribunal cited specific UNIDROIT Principles; *inter alia*, the provisions on hardship. The analysis of the substantive content of specific UNIDROIT provisions is a bold step [430] towards the process of adapting contract-law provisions to the needs and specificities of international investment law,[431] and recognizing the relevance of contractual principles for the adjudication of treaty standards.

While the focus of *El Paso* was on one of the elements of hardship, i.e. the condition of the non-contribution of the state to its occurrence, the very use of the Principles in the context of investment-treaty disputes sets the scene for their broader application for resolving treaty claims. This is particularly important for the legal effects of hardship, namely the legality and legitimacy of contractual renegotiations, emphasized in the dissenting opinion of arbitrator Pedro Nikken in the *Aguas Argentinas* case, which shed much-needed light on the legal importance and effect of the renegotiation of Argentina's concession contracts.

In particular, *Nikken* disagreed with the inclusion of "legitimate expectations" as an element of the "fair and equitable treatment" standard, which it connected instead with the UNIDROIT Principles of hardship, arguing that they are the appropriate legal standard for evaluating the legal effects of the renegotiation process *per se*. *Nikken* also disagreed with the reasoning of the majority, according to which the renegotiation process itself constituted a violation of "fair and equitable treatment",and pointed out that the renegotiation of long-term concession contracts is far from exceptional and it had been common practice for the Claimants themselves, when they were faced with changed circumstances.

In addition to the previous behavior of the parties that endorsed renegotiation as a common practice, *Nikken* also argued that, from a strictly legal point of view, renegotiation was perfectly justified, and opposed the majority's assumption that the foreign investor was coerced into acceding to the renegotiation process. He cited in this regard Article 5.1 of the concession contract prescribing the parties' obligation to "use all

[430] This development in investment-treaty arbitration is interesting given the fact that even in purely contractual cases reference to the Principles is usually more generic and limited to the Preamble. See Steingruber, M. (2013), *El Paso v. Argentine Republic: UNIDROIT Principles of International Commercial Contracts as a reflection of "general principles of law recognized by civilized nations"* in the context of an investment-treaty claim, Uniform Law Review, 18 (3-4): 509, at 522.
[431] Id., at 538.

means available to establish and maintain a fluid relationship which would facilitate the discharge of this Concession Agreement."

More importantly, he reasoned that the "international legal standard" to address hardship in these cases is the "obligation" of the parties to "renegotiate" their relationship in order to adapt their contract to the altered circumstances. He noted that the duty of renegotiation is a corollary of the "duty of good faith" inspiring the governance of every contract. In addition to the aforementioned reference to the contract, *Nikken* also specifically cited the UNIDROIT Principles of International Commercial Contracts, namely the provisions defining hardship and determining its legal effects, thus arguing for a clear connection between the two instruments, the contract and the treaty.[432]

The recognition of the defense of hardship under international law has significant legal effects for the renegotiation of investor-state contracts. The fact that the renegotiation process *per se* is under certain conditions legal and legitimate, thus precluding both wrongfulness and liability, has concrete repercussions for the long-term governance of concession contracts. The following section puts forward certain recommendations for the efficient renegotiation of state contracts in the event of hardship.

(D) Policy implications for the renegotiation of state contracts

This last section summarizes the main elements of the defense of hardship and elaborates on the design of this general principle in a way that it can be adapted and applied to the field of international investment law. This section is partly prescriptive in the sense that, taking stock of the aforementioned state of application and evolution of the relevant UNIDROIT Principles in investment arbitration, it recommends a design for the incorporation of the hardship defense in investor-state dispute settlement.

The integration of the renegotiation process - as the legal effect of hardship - into the investor-state dispute settlement system would reduce the transaction cost of opportunism in the governance of concession contracts by filtering out frivolous arbitration claims and facilitating the early and amicable resolution of disputes ensuing from such contracts. The legal obligation of the contractual parties to renegotiate in good-faith in the event of hardship would dis-incentivize any recourse to investment arbitration to claim a treaty breach as a quasi-automatic result of the contractual renegotiation. On the contrary, it would force the parties to engage constructively and cooperate in order to renegotiate their contract by sharing equitably the burden of hardship. Such reform of investment arbitration would thus place more emphasis on the good-faith cooperation of the parties

[432] See the Separate Opinion of Arbitrator Pedro Nikken, paras 45-50, note 35.

and the sustainable governance of their partnership, instead of allowing only for compensation claims based on a broken relationship.

As prescribed in Article 6.2.3 of the UNIDROIT Principles, there are, specifically, two legal effects and steps ensuing from the occurrence of hardship. The first is the amicable renegotiation between the parties with a view to adjusting their contract to the changed circumstances. Upon the potential failure of these bilateral negotiations, a court or arbitration procedure will take over in order to achieve the adaptation (or termination) of the disputed contractual relationship. Transposing these legal effects to international investment law means that the renegotiation process should be conducted through mediation, as an impartial and transparent mechanism ensuring the de-politicization of the renegotiation process.

Applying the UNIDROIT principles on hardship as the appropriate legal standard to evaluate the conditions and effects of renegotiation means that the distressed party has the "right" to request the renegotiation and adaptation of the contract to the new circumstances. Given the fact that under these conditions renegotiation is "both legal and mandatory" for the other party the main concern is to ensure that it is conducted through due process. Mediation could play precisely the role of guaranteeing that the conditions under which renegotiation takes place are fair and equitable for both parties.

The critical legal effect of a mandatory, yet procedurally just, renegotiation process would be the impact of the latter on the adjudication of the fair and equitable treatment standard. To the extent that the renegotiation of the contract had been the fair product of mediation and not the result of the unilateral and arbitrary exercise of public power by the state, a breach of the FET standard as a consequence of the renegotiation process would be "precluded". In other words, by regulating the renegotiation process in international law and making it transparent and visible to arbitrators, the distinction between a potential breach of the treaty as a result of the exercise of sovereign power and a mere contractual breach will be less contentious, especially in light of the *de facto* difficulty to distinguish between contract and treaty claims.

More specifically, the catalytic role of mediation for the legality of renegotiation would have a dual effect on the evaluation of an alleged breach of FET. For one part, it would ensure due process and the balance of powers between the parties. A second and equally important advantage is that it would dissuade frivolous, opportunistic, or abusive resort to arbitration for claims of breach of FET as a result of renegotiation, as the latter would be judged legal if the conditions of the UNIDROIT Principles are fulfilled.

Overall, a mandatory renegotiation process conducted through mediation would "force parties to cooperate" and renegotiate to their mutual benefit, thus achieving a better

alignment of their incentives to collaborate and decreasing the behavioral risk of opportunism. Such effective cooperation would help sustain the contract and contribute to the effective long-term governance of PPPs, ultimately contributing to the maintenance of strong business ties between the parties and the development of the economy of the host state - which is after all one of the main objectives that states signing international investment treaties aim to achieve.

4. Treaties as Contracts

a) *Overview*

In addition to the tangible and inextricable relationship between investment treaties and the underlying concession contracts that the aforementioned instruments attest to, the strong similarity of international treaties with contracts is widely evidenced also in the literature. The conceptualization of treaties as contracts is not a new idea. Already in the seventeenth century *Hugo Grotius* held that treaties are analogous to contracts in civil law. Ever since, lawyers have affirmed that treaties work the same way as contracts to create obligations.

Lauterpacht, in his seminal monograph on private law analogies in international law, observes that international law ultimately adopts solutions given by private law, and makes particular reference to international arbitration in this regard. He stresses that recourse to private law on the part of both states and tribunals is a frequent, if not permanent, feature of international arbitral proceedings, and a great deal of awards have adopted such approach.[433]

The recourse, in international arbitration, to private law flies in the face of positivism in treaty interpretation. Whereas the science of international law rejects, under the influence of the positivist theory, the application of any analogy to international law, the more pragmatic approach of international relations gives rise to such analogies, especially in cases where international law is not developed enough to provide adequate responses to the legal questions at hand.

Such is the extent of positivism in international law that, even in cases where the treaty itself includes private-law concepts, positivists refuse to acknowledge that such recourse

[433] Lauterpacht, H. (1926), *Private law analogies in international law*, PhD thesis, The London School of Economics and Political Science (LSE), III.

can even take place, let alone render any assistance in interpreting those concepts. In the investment-law sphere an evident example of such treaty reference to private law are the provisions on umbrella clauses.

Criticizing the positivist approach, *Lauterpacht* takes a realist perspective on international law, drawn from international relations and the actual practice of states.[434] Parting with the civil law tradition that is hostile to transplanting private-law concepts into international law, he sides with common-law, namely English and American publicists, who do not hesitate to attribute to Roman law the capacity of filling the numerous gaps in international law.

Lauterpacht observes, nevertheless, that despite formally rejecting the private-law analogy, classical and positivist writers in fact take over its rules and concepts albeit under a different name, such as "natural law", or "general principles of law". He concludes with a reference to international arbitration as the field where all those principles of private law generally accepted and embodying a rule of justice and common sense, are also accepted as principles of international law, such as the principle of estoppel.

Following humbly the footsteps of *Lauterpacht*, this thesis is inspired by a similar rationale and motive of departing from the positivist tradition of interpreting investment treaties using a monocular and polarized approach of public vs. private law. On the contrary, taking an "integrated systems approach",[435] it constructs an original interpretative framework, based on relational contract theory and inspired by the common-law approach, which, while respecting the interpretative rules of the Vienna Convention, also goes beyond the "four corners" of the treaty by looking into the "law in action" and creating hybrid interpretative methods for hybrid regimes (as investment arbitration is).

Lauterpacht is not the only scholar that has exposed (so early on) the blurred distinction between private and public, or - for the purposes of treaty interpretation - between the contract and the treaty. The conceptualization of treaties as contracts has been a perspective widely supported in the literature, and so has been the application of the pragmatic perspective of international relations to international law.

Setear, in particular, has argued that the adoption of the international-relations perspective, and especially institutionalism (or regime theory), can remedy the dual isolation of international legal scholarship - particularly as regards the interpretation of

[434] Id., IV.

[435] Maupin, J. (2014), *Public and Private in International Investment Law: An Integrated Systems Approach*, Virginia Journal of International Law, 54 (2): 1.

treaties - from economic theory and international politics. Similar to the transaction-cost-economics perspective, *Setear's* institutionalist theory aims at encouraging repeated interactions among nations and adopting strategies tending to foster international cooperation.[436]

This thesis endorses the iterative perspective, as a legal realist and interdisciplinary approach that correctly predicts important aspects of treaties beyond the general, procedural aspects governed by the law of treaties. Indeed, the herein proposed interpretative framework predicts strategies enforcing international cooperation not only between states but also between the host state and a *de facto* increasingly important international actor, the foreign investor). The iterative perspective is also in line with the school of critical legal studies, which has demonstrated that the positivist, rule-based approach to international legal scholarship is clearly incomplete, and of the sort of "European doctrinal formalism".[437]

Additionally, the main elements of the institutionalist approach that this thesis particularly endorses, are the theory's emphasis on the proper design of incentive structures (including the management of information and transaction costs as game-theoretical concepts), and the need for flexibility and dynamism when interpreting treaties containing "dynamic obligations". This is precisely the nature of the vague and dynamic standards included in investment treaties, which thus call for the application of the dynamic interpretative methods that relational contract theory offers.

Indeed, *Abbott*, one of the pioneers in applying the pragmatic perspective of international relations to the law of the treaties has provided examples of international legal methods that can broaden cooperative options building on the proper design of incentives,[438] and the proper way to govern the production and verification of information.[439] On the other hand, *Smith* has also pointed to structural features in international treaties that undercut the relevance of the static, formalistic analysis - which the author finds to be typical of international legal scholarship - and has emphasized instead the importance of flexibility and dynamism in treaty interpretation by drawing on the theory of relational

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[436] Setear, J. (1996), *An Iterative Perspective on Treaties: A Synthesis of International Relations Theory and International Law,* Retrieved from: http://faculty.virginia.edu/setear/cv/hilj.pdf. On the connection between state practice, as attested in international relations, and transaction costs economics, see Aceves, W. (1996), *The Economic Analysis of International Law: Transaction Cost Economics and the Concept of State Practice,* University of Pennsylvania Journal of International Law, 17 (4): 995.

[437] Kennedy, D. (1988), *A New Stream of International Law Scholarship*, Wisconsin International Law Journal, 7 (1):1, at 3.

[438] Abbott, K. (1989), *Modern International Relations Theory: A Prospectus for International Lawyers*, Yale Journal of International Law, 14 (2): 335.

[439] Abbott, K. (1993), "Trust But Verify": The Production of Information in Arms Control Treaties and Other International Agreements, Cornell International Law Journal, 26 (1): 1.

contracting.[440] *Slaughter* takes the discussion even further by focusing on the institutional elaborations that regimes offer to lessen information and transaction costs,[441] as well as the functionalist apparatus of international law developed especially by *Henkin* and *Chayes*.[442]

The importance of international relations and the creation of "incentives for cooperation" (as opposed to a merely positivist view of treaties) has also been at the center of the analysis of contract theorists coming more a law-and-economics background. In the *Limits of Leviathan*, *Scott* and *Stephan* note that, although nations may conform to international rules and norms for many reasons, the animating purpose of much of international law is to foster mutually beneficial inter-state cooperation. They also observe that contract is the means for attaching legal consequences to the states' commitments to achieve cooperative goals, and that such a link between mechanisms of private contracting and the purposes of international law has long been recognized.[443]

Of particular relevance for the interpretation of international treaties are the elements of contract theory addressing the trade-off between "hard" and "soft" terms, or otherwise "rules" and "standards". The first are included in complete contracts anticipating fully and accurately the values expected at the time of performance, which however, will always be wrong under conditions of uncertainty, thus calling for a renegotiation of the contract *ex post*. On the other hand, when contracting costs are high – as are in the case of investment treaties - the parties will opt for "soft" terms, or broad standards requiring subsequent "good-faith adjustments" and deferring the filling of their gaps to the enforcement phase.[444] The inclusion of "standards" (like FET) in investment treaties attests their as inherently incomplete contracts delegating significant decision-making power to arbitrators.

Apart from the literature, the analogy of treaties with contracts is also supported in case law. The U.S. Supreme Court has long stated (*inter alia*, in the decision of *Olympic Airways v. Husain*) that treaties adopted under Article II of the Constitution are not acts of "legislation" but rather "contracts" between sovereign nations. The same view had already been endorsed in England, with Chancellor Kent stating that treaties are much like private contracts, and should thus receive a fair and liberal, good-faith interpretation,

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[440] Smith, E. (1991), *Understanding Dynamic Obligations: Arms Control Agreements*, Southern California Law Review, 64: 1549.
[441] On the application of regime theory to international investment treaties, see Salacuse, J. (2010), *The Emerging Global Regime for Investment*, Harvard International Law Journal, 51 (2): 427.
[442] Slaughter Burley, A.M. (1993), *International Law and International Relations Theory: A Dual Agenda*, American Journal of International Law, 87 (2): 205, at 207-220.
[443] Scott, R. & Stephan, P. (2006), *Lessons from Contract Theory*, in: *The Limits of Leviathan, Contract Theory and the Enforcement of International Law*, Cambridge University Press, at 59.
[444] Id., at 77.

while their meaning should be ascertained by the same rules of construction and course of reasoning applicable to the interpretation of private contracts.[445]

Despite the recognition, though, of the contract analogy, the "new textualism",[446] as championed in particular by Justice *Scalia*, has marked the Supreme Court's treaty jurisprudence.[447] As *Mahoney* notes, the coexistence of these two themes in treaty jurisprudence – textualism and contractual methodologies – is problematic. Whereas the text of the contract serves only as "evidence" of what the agreement is,[448] the text of the statute "is" the agreement. As a result, the interpreter's tasks are very different depending on the approach taken. An interpreter in a contractual dispute aims primarily at identifying how the parties themselves would interpret the terms of their contract, whereas an interpreter of statutes using the textualist methodology restricts herself to identifying "the ordinary meaning" that a neutral third party would give to a term of the statute.[449]

b) *Textualism vs. Contractualism*

Mahoney argues that between the two contending principles of treaty interpretation, textualism and contractualism, the contract analogy should prevail. He contends that the strongest justifications for textualism in statutory interpretation do not apply in the treaty context,[450] and that, from a practical point of view, it is harder to apply textualism to treaty interpretation, because the interpretative aids that textualists apply – especially linguistic canons – are inappropriate for resolving ambiguities in treaties.[451] He also considers the contract approach to have strong roots in the Constitution, and maintains

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[445] Kent, J. (1826), *Commentaries on American Law*, Vol. I, New York: O. Halsted, at 163.
[446] The term "new textualism" was coined by Professor William Eskridge to describe the interpretative methodology restricting interpretation to the four corners, that is, the text of the agreement, by excluding any contextual evidence. See Eskridge, W. (1990), The New Textualism, UCLA Law Review, 37: 621.
[447] Mahoney, C. (2007), *Treaties as Contracts: Textualism, Contract Theory, and the Interpretation of Treaties,* Yale Law Journal, 116 (4): 824, at 826. Nevertheless, even Justice Scalia nodded to the contractual nature of treaties in the Olympic Airways case by acknowledging that judicial opinions from foreign signatories are evidence of the original shared understanding of the contracting parties. Id., at 832.
[448] On contracts as only evidence, or "reference points", and not the only source of interpretation, see Hart, O. (2008), *supra* note *Contracts as Reference Points*. On contracts as only parts of wider relationships, see Teubner, G. (1993), Law as an Autopoetic System, Oxford/Cambridge, Blackwell Publishers. *Macaulay* has also long observed that businessmen use contract law as a safety-net rather as the sole guide for their actions. See Macaulay, S. (1963), *Non-Contractual Relations in Business: A Preliminary Study*, American Sociological Review, 28 (1): 55.
[449] See Mahoney, C., *supra* note 405, at 827.
[450] *Neilson* contended already in 1829 that a treaty is its nature a contract between two nations, not a legislative act.
[451] *Allott* has also pointed to the more incomplete nature of international treaties because of high transaction costs and future uncertainties, compared to national texts. See Allott, P. (1999), *The Concept of International Law,* The European Journal of International Law, 10 (1): 31.

that contract theory could succeed where existing treaty doctrine fails, by providing a consistent framework for courts to use when resolving ambiguities in treaties.

Mahoney also specifically emphasizes the relevance of relational contract theory for developing new canons of treaty interpretation. The author makes a distinction between contract formalism - textualism's private-law cousin, as he characterizes it - [452] and relational contract theory. Whereas the former would continue to play a role in treaty interpretation, particularly for treaties of limited scope resembling one-off, discrete commercial contracts, treaties governing recurrent interactions between parties over a long period of time require the use of more flexible interpretative methods. *Mahoney* adds that, in the context of such "relational" treaties, the range of interpretative sources available would be much broader than those deployed by textualists in the statutory context.[453]

The debate between textualism and contextualism holds also in the context of contract interpretation. *Scott* observes that modern contract law is nominally unitary, meaning that it rests on the premise of a single set of rules applicable across the board to all types of contractual relationships, no matter how different these are from each other. He finds this inefficient uniformity to ensue from the polarized debate between textualist and contextualist theories of interpretation.

The effects of the choice between the two theories are clear: the textualist plain-meaning rule fits with the hard "parol evidence" rule that aims to reduce adjudication costs but comes at the cost of trimming the "context evidence" available to the court.[454] The "contextual interpretative method", on the other hand, shifts the transaction costs from the drafting or "front end" of the contracting process to the "back-end", litigation phase.[455] Parties writing simple contracts in rich context environments [456] can thus economize on "front end" costs and delegate discretion to adjudicators to interpret the express terms in light of the "context evidence" revealed in a full trial.

Scott observes that American common law has managed to merge (even in a delicate balancing exercise) textualism and contextualism, as American contract interpretation applies both the doctrines produced by English common law, and the equitable principles originating in the English Court of Chancery, which require judges to exercise discretion

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[452] Or in other words discrete, classical contracts.
[453] See *Mahoney*, C., *supra* note 405, at 827.
[454] Scott, R. (2013), *Text versus Context: The Failure of the Unitary Law of Contract Interpretation*, in: Buckley, F., *The American Illness: Essays on the Rule of Law*, Yale University Press, at 7.
[455] See Scott, R. & Triantis, G. (2006), *supra* note 68.

[456] As international investment treaties are, given the brevity and vagueness of their standards, yet the wide universe of cases and contexts in which those standards apply.

on a case-by-case basis. This means that along with the historical legal contract doctrines, such as the plain meaning rule and the parol evidence rule, American contract law has also absorbed interpretative doctrines of equity, thus rendering contract interpretation torn between the prospective regulatory approach focusing on the four corners of the disputed contract, and the retrospective dispute-resolution perspective of equity.[457]

It was the school of legal realism, namely *Arthur Corbin* and *Karl Llewellyn*, that uncovered the underlying tensions between law and equity. In particular, *Corbin* has argued that the *Willistonian* rules governing interpretation[458] are empty formalizations and interpretation issues are context-specific.[459] He has also maintained that courts apply rules tactically in order to pursue overarching policy principles of fairness and natural justice.[460]

According to *Corbin*, courts are called to determine the actual intention of the parties, and all relevant evidence should be considered on the issue of intent.[461] As a result, the very evidence the inadmissibility of which has been challenged, would be admissible as regards the question whether or not the writing alone is to govern.[462] It is evident that *Corbin's* approach has weakened severely the application of the traditional parol evidence rule. "In order for the court to reach a just result, the context of the transaction is a necessary, in fact an essential, feature of any adjudication." [463]

Llewellyn, for his part, has taken the contextualist argument even further by maintaining that the courts should seek the "situation sense" of a bargain by locating it in the "practices" of the commercial parties. He has equally argued for the incorporation of the parties' "extra-contractual practices" into the terms of their agreement. To this end, while

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[457] See Scott, R., *supra* note 413, at 8.

[458] Williston's formalism rests on the following basic claims: contract terms could be interpreted according to their plain meaning, and written terms have priority over unwritten expressions of agreement. See Williston, S. (1959), A Treatise on the Law of Contracts, New York: Baker Voorhis and Co.

[459] *Klabbers* also supports the view that unity in interpretation cannot be created by the mechanistic reliance on written rules alone, no matter how clever the rules may be. See Klabbers, J. (2010), *Virtuous Interpretation*, in: Fitzmaurice, M., Elias, O. & Merkouris, P., *Treaty Interpretation and the Vienna Convention on the Law of Treaties: 30 Years on*, Brill, at 35.

[460] All interpretative methods described above seem to converge on the acceptance that arbitrators bear wide decision-making authority (with the common law approach acknowledging more saliently this reality). As regards specifically the tactics, or the politics of international arbitrators, see the relevant section *infra*.

[461] Corbin, A.L. & Perillo, J.M. (1951), *Corbin on Contracts*, Matthew Bender, para 577

[462] Id., para 582.

[463] Id., paras 24.7-24.9 (emphasis added). *Corbin's* approach is that, even if the contract was an unambiguous integration (which is certainly not the case with the vague, inherently incomplete, and dynamic standards of investment treaties), *all relevant extrinsic evidence* should be admissible on the issue of the meaning of the agreement. See Scott, R., *supra* note 413, at 9. Taking into account evidence extrinsic to the text of the agreement – be that the treaty or the contract – has obvious consequences for the adjudication of vague treaty standards, especially FET, especially when it comes to taking into account the context of contractual renegotiations in determining whether these amounted to a breach of FET or not.

drafting those provisions of the Uniform Commercial Code governing contracts for the sale of goods, *Llewellyn* reversed the Willistonian presumption that the parties' writings are the definitive elements of the agreement. As a result, Article 2 of the UCC explicitly calls for an examination of the context by defining the content of an agreement broadly enough to incorporate "trade usage, prior dealings, and the parties' experience in forming the contract." [464] The parol evidence rule under the Code thus admits "inferences" from trade usage "even when the express terms" of the contract seem to be perfectly clear and unequivocal.[465]

Alstine has also repudiated the "new textualism" school, by arguing instead in favor of an internal filling of gaps and resolution of ambiguities in treaties based on the "general principles" interpretative methodology. His focus is on the role of domestic judges in interpreting international law, and the ensuing risk of restricting international uniformity produced through a treaty due to a restrictive formalistic interpretation permitting domestic adjudicators to embrace their natural bias for familiar domestic legal norms while filling gaps in international treaties.[466]

Despite *Alstine's* specific interpretative focus on the interpretation of international treaties by domestic judges, his rationale for an "internal-development methodology", based on "general principles", can evidently apply by analogy to the interpretation of investment treaties. In this context, the internal-development (including gap-filling) methodology would entail the delegation of interpretative authority to arbitrators, who would be called to resort to "general principles" to interpret vague treaty terms, instead of institutionalizing the permanent interference of states in treaty interpretation, namely through the use of administrative committees.

A topical example of the importance of "extra-contractual context" for defining the content of the contractual obligations of the parties, are the *Kharkiv Accords* between

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[464] Emphasis added. UCC para 1-201(3) (2010) defines "agreement" as "the bargain of the parties in fact as found in their language *or by implication from other circumstances, including course of dealing or usage of trade or course of performance* as provided in this act." Emphasis added.

[465] There is an increasing acceptance of inferences in international arbitration, even of adverse inferences (in line with the logic of penalty default rules, proposed in the last Chapter), as demonstrated, for example, in the decision of Paris Court of Appeal. The Court has approved the drawing of adverse inferences by tribunals in compliance with the *IBA Rules on the Taking of Evidence in International Arbitration*, thus refusing to set aside an ICC award against Siemens-affiliate Dresser-Rand, which was based on such inferences. See http://globalarbitrationreview.com/article/1137955/use-of-adverse-inferences-approved-by-paris-appeal-court

[466] Alstine, M. (1998), *Dynamic Treaty Interpretation*, University of Pennsylvania Law Review, 146: 687, at 693-694. Indeed, as Bjorge has observed, domestic judges can diverge in their choice between a "statutory" or a "contractual" interpretation of treaties, with the French courts being in general more favorable to an overly literal treaty interpretation, while the British courts seem to show a preference for a more teleological approach. See Bjorge, E. (2015), *"Contractual" and "Statutory" Treaty Interpretation in Domestic Courts? Convergence around the Vienna Rules*, in: Aust, H. & Nolte, G. (Eds.) *The Interpretation of International Law by Domestic Courts*, Oxford University Press, at 49-50.

Russia and Ukraine, whereby Russia offered Ukraine a discount for its gas imports. Following the unilateral cancellation of the Accords by Russia after its annexation of Crimea, and in light of the current arbitral disputes between *Naftogaz* and *Gazprom* on their supply and transit contracts, a question is whether the *Kharkiv Accords* shall be taken into account as part of the context of those contracts, and in particular as extra-contractual practice of the parties that had as a result the renegotiation of the disputed contracts.[467]

Of course, all in all, rules or no rules, method or no method (and the mechanic reliance on them, or not), in the final analysis interpretation is a human activity depending on the efforts of human beings, their sensibilities, and their sense of virtue.[468] Even the hierarchically most superior rules get circumvented when the ends justify the means.[469] As the constitutional theorist, *Jeff Powell*, highlights, judging is not simply a matter of applying rules to facts, or simply applying personal politics to cases. Instead, judging is a moral activity, tapping into the adjudicator's individual obligations as a moral actor.[470] *Powell* argues that a judge (or another interpreter for that matter, namely an arbitrator) is called to make choices between often equally plausible or possible alternatives, and those choices, *Powell* insists, are moral choices.[471] To quote also *David Kennedy*, interpretation is the functional equivalent of truth, helping to curb power. As *Kennedy* has observed, through interpretation "power seems tamed despite the unavailability of a workable picture of truth." [472]

As *Koskenniemi* has also put it, the interpretative techniques lawyers use to proceed from a text or a behavior to its meaning, "create" (and not simply reflect) those meanings. It follows that whoever controls the interpretation process, therewith controls the truth, or at least the meaning to be imparted to the text subject to interpretation.[473] As a result, interpretation equals power, and deciding on the interpretative method to be deployed also entails dictating the terms of a legal instrument.[474]

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[467] These disputes also exemplify the strong connection between the contract and the treaty, as the contractual instruments between *Naftogaz* and *Gazprom* were modified by means of a subsequent inter-governmental agreement between Ukraine and Russia.

[468] As T.S. Eliot has said in *The Sacred Wood*, there is no method but to be very intelligent.

[469] See Klabbers, J., *supra* note 419, at 35. As aforementioned, one of the following sections will elaborate more on the role of the politics of arbitrators in treaty interpretation.

[470] Powell, J. (2008), *Constitutional Conscience: The Moral Dimension of Judicial Decision*, The University of Chicago Press, at 3.

[471] Id., at 107-110.

[472] Kennedy, D. (1985), *The Turn to Interpretation*, Southern California Law Review, 58: 251, at 251-275.

[473] Koskenniemi, M. (2005), *From Apology to Utopia: The Structure of International Legal Argument*, Cambridge Books Online, at 597.

[474] On the observation that interpretation decides not only on *how* to interpret but also on *what* to interpret, see Cotterell, R. (1989), *The Politics of Jurisprudence: A Critical Introduction to Legal Philosophy*, University of Pennsylvania Press, at 179-180.

c) *Dynamic Treaty Interpretation and Relational Contract Theory*

The debate on classical vs. relational contractual theory is an extension of the debate on textualism vs. contractualism. As a matter of fact, classical contract theory is the equivalent of textualism, wherein the emphasis is on the textual analysis of the ordinary meaning of the terms used in the contract. On the contrary, the relational-contract approach focuses instead on the overall context of the contractual implementation, including the potential renegotiation of the contract (and the conduct of the parties during that process).

If the application of contract theory to treaty interpretation has been strongly opposed by the textualists, then the application of relational contract theory in particular is an even more novel and underdeveloped idea. Building on the contextual approach to treaty interpretation that general contract theory promotes, the relational theory goes a step further in identifying the context of the contractual relationship by inserting the factors of mutuality and dynamism into the contractual equation.

As an initial remark, the reservations deriving from public choice theory and referring to the dynamic interpretation of statutes do not apply in the case of treaties. To take the example of the American legal system, the bicameralism and presentment provisions of the Constitution aim at carefully balancing deals among competing interest groups. In this context, deciding what competing values will or will not be sacrificed to achieve a particular objective is the very core of the legislative choice, and many laws constitute compromises going thus far and not further in the pursuit of such objective.[475]

As a result, in the statutory context, the textualist argument is that a departure from the text seriously disrupts the delicate compromise achieved through the legislative process. In other words, textualists argue that a dynamic approach to statutory interpretation, whereby judges act on extratextual sources that did not go through the bicameralism and presentment process, risks disrupting the inherent *status-quo* bias of this legislative process and giving effect to the text that a legislative minority could not enact.

Moreover, a purpose-based judicial interpretation of a statute would allow legislators to pass off difficult policy choices to others, thus sabotaging electoral accountability. Textualism aims to prevent such strategic obfuscation by limiting judicial enquiries to the face of the statute. *Mahoney* concludes that, in this sense, textualism serves as a type of

[475] See Mahoney, C., *supra* note 101, at 839.

"penalty default rule" that systematically penalizes Congress when it tries to delegate difficult policy choices to the judiciary.[476]

The author also observes that there is less cause for textualism as the default rule in the treaty context. The assumption underlying the textualist default rule for statutory interpretation is that the legislature has perfect information about the decisions that courts make, and textualist judges will exert pressure on Congress to legislate with more precision. Indeed, the Congress, being a fixed assembly convening regularly and including specialized committees that monitor decisions on particular topics, can in theory correct court interpretations with which it disagrees.[477]

However, the practicability of such regular interference of the legislature with court decisions on statutory interpretation has been questioned, as has the assumption of the legislature's perfect information. Among others, Professor *Katzmann* considers the legislative correction of the courts' statutory interpretation unlikely, because legislators lack awareness of the problem.[478] Similarly, empirical studies show that textualism does not appear to have made statutory interpretation a predictable enterprise.[479]

Nevertheless, *Eskridge* has noted that standing committees are key facilitators of the Court-Congress interaction, which is a factor that has been missing from the treaty context. A recent proposal that seems to be moving towards this direction has been the establishment of a Joint Committee as well as specialized committees in the context of the interpretation of EU-Canada Comprehensive Economic and Trade Agreement (CETA).

Despite the utility of such committees for delegating back to the states interpretative authority,[480] the inherent incompleteness and dynamism of the broad and vague standards included in investment treaties cannot be cured through regular state interventions to the decision-making process of arbitrators (unless the very purpose of the de-politicization of the resolution of investor-state disputes is dispensed with and replaced with the initial system of diplomatic protection).

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[476] Id., at 841. The mechanism of penalty default rules is endorsed herein as well, but in a different sense, as those burden-of-proof rules penalizing the disputing party that does not disclose evidence by withholding material information. As will be explained below, the penalty of such rules on evidence consists in drawing adverse inferences from the non-disclosure of requested information.
[477] Id., at 843.
[478] Katzmann, R. (1992), *Bridging the Statutory Gulf Between Courts and Congress: A Challenge for Positive Political Theory*, Georgetown Law Journal, 80: 653.
[479] Ruger, T. (2004), *The Supreme Court Forecasting Project: Legal and Political Science Approaches to Predicting Supreme Court Decision-making*, Columbia Law Review, 104: 1150.
[480] On the delegation of interpretative authority to joint commissions, see Van Aaken, A., *supra* note 61.

On the contrary, arbitrators are by definition delegated with wide interpretative and decision-making authority in their duty to apply inherently incomplete and vague treaty standards,[481] and are thus inevitably engaged in making policy choices. The question thus is "what the proper interpretative method" is to assist arbitrators in living up to the moral duty they have to deliver fair and equitable judgments that involve sensitive policy evaluations.

The reason why investment treaties should be interpreted according to the tenets of relational contract theory, is the crucial importance of not only contextualism, but also dynamism and mutuality, for imparting meaning and effect to the vague treaty standards, especially the standard of fair and equitable treatment, and the doctrine of "legitimate expectations" as one of the standard's components.

Already back in the '90s, one of the aforementioned pioneers of the iterative approach to treaty interpretation, *Smith*, characterized those treaty provisions that stipulate evolving commitments as "dynamic" obligations, and connected dynamism with reciprocity (or, mutuality) in observing that reciprocal behavior among the parties "increases the probability of continued compliance" with dynamic obligations. He also noted that dynamic obligations cannot be fully explained by traditional doctrinal approaches based on narrow consent-based theories, which only provide tools to evaluate legality but do little to address "uncertainty". On the contrary, the understanding of dynamic obligations presupposes, instead, an appreciation of international regimes, relational contracts and reciprocity.[482]

To this end, *Smith* highlights the change of the nature of the treaties from "static" [483] frameworks to agreements establishing continuing, dynamic relationships. He notes that traditional doctrines had protected the fixed expectations of the parties without allowing for flexibility, as a necessary component of the cooperative enterprise, nor for the evolution of the parties' obligations and, consequently, the continued viability of their relationship. Under the conventional doctrine – *Smith* argues – the extent of a state's obligations were based upon either a textualist interpretation or a contextual (intent-based) but static interpretation, neither of which allows for mutually beneficial "adaptive" responses to changed (*inter alia*, economic or political) circumstances.[484]

It is evident that, already at the time that *Smith* wrote his criticism on traditional interpretative rules, the VCLT had proved inadequate to respond to the interpretative

[481] They only differ in the methods proposed for fulfilling such duty of interpretation and decision-making.
[482] See Smith, E., *supra* note 397, at 1549.
[483] On statism as an element of classical contract theory – i.e. the private-law equivalent of textualism - (as opposed to relational contract theory), see *supra* Chapter I on the analysis of the characteristics of the different categories of contracts.
[484] See Smith, E., *supra* note 397, at 1577.

challenges posed by dynamic treaties. *Kearny* and *Dalton* have also characterized its provisions "archaic and unduly rigid",[485] and failing to distinguish between different types of treaties serving different functions.[486] *Sinclair* has concurred with this observation by highlighting that the VCLT's traditional rules do not reflect the actual practice of international tribunals.[487]

Smith's conclusion regarding the Vienna Convention is that its traditional rules offer little guidance for parties dealing with ongoing disputes over the present character of evolving obligations.[488] This is especially due to the fact that they are based on the false assumption that the ensuing disputes over the meaning of dynamic obligations are brought before neutral tribunals. The limited interpretative utility of the VCLT ensues equally from the purpose of the Convention's drafters to lay down procedural rules governing international treaties, and not to address the changing character of substantive international obligations. In a nutshell, the VCLT's traditional doctrines grew out of the formalistic, consent-based concept of static obligations that resulted from conventional, static treaties (such as those resolving boundary disputes).[489]

On the other hand, the author sees great potential in relational contract theory and the theory of international regimes for interpreting dynamic treaty obligations. At the core of both fields are the concept of cooperation and the promotion of mechanisms that can promote the cooperative enterprise. Relational contract theory can serve as a useful analogy for determining the content of the theory on international regimes, as the broader context within which cooperation takes place.[490]

Before elaborating on the relational characteristics of investment treaties in particular, it is worth examining the relevance of relational contract theory for interpreting dynamic

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[485] Kearny, R. & Dalton, R. (1970), *The Treaty on Treaties*, American Journal of International Law, 64 (3): 495, at 520. It is remarkable that already back in the 70s legal realists had pointed to the substantial limits of the Vienna Convention, by characterizing already back then its provisions archaic and inapt to adjust to the changed needs of states and the evolving nature of treaties.

[486] Much like most of the ISDS literature fails to distinguish between the different categories of disputes falling under ISDS – with the exception, for example, of *Maupin*, which is the approach adopted herein.

[487] The following section, which focuses on the review of the case law on the alleged causation between the renegotiation of concession contracts and the breach of a treaty standard, will deal with the question of the interpretative methods that arbitrators have deployed in identifying the meaning of treaty standards in dispute, especially FET.

[488] *Pauwelyn* characterizes the Vienna Convention as an incomplete contract itself, and mentions the example wherein a WTO panel is called to give meaning to one incomplete contract (the WTO treaty) using another incomplete contract (the VCLT) as guidance. See Pauwelyn, J. & Elsig, M. (2011), *The Politics of Treaty Interpretation: Variations and Explanations Across International Tribunals,* Retrieved from:
http://graduateinstitute.ch/files/live/sites/iheid/files/sites/ctei/shared/CTEI/Pauwelyn/Publications/Pauwelyn-Elsig%20Corrected%20Proofs%20(1).pdf

[489] See Smith, E., *supra* note 397, at 1582.

[490] Id., at 1585 et seq.

treaties in general. First, much like relational contracts, dynamic treaties are context-specific, meaning that the specific relationship within the framework of which the treaty is implemented, can often explain far more than the legal rules alone can. Second, those traditional legal rules alone cannot define all the "commitments" that flow from formal agreements creating dynamic obligations, but special norms and additional commitments also arise from any other arrangements and "patterns of interaction" of the parties to the relational contract.

For example, much like a state's unilateral representations can create commitments based on obligations of good faith, in a relational environment, the investor's conduct can also create legitimate expectations to the host state.[491] In particular, renegotiation patterns developed between the parties can also create expectations to both parties, which would arise from the establishment of working practices of adapting the contract to their changed circumstances and needs in a mutually beneficial way.

Such relational considerations have an impact not only on the performance of a contract but also the character of the ensuing dispute resolution system. As Professor *Gottlieb* has noted, juridical activities in relational societies are less litigious and more focused on the practices of actors, and their usages, customs and interpretations that mediate between the parties' actual patterns of conduct and the formal juridical instruments deemed to govern them.[492] Evidently a request for renegotiation of the formal agreement of the parties, and the renegotiation process taking place outside the context of any contractual provisions, are extra-contractual practices of extreme significance for the implementation of the contractual relationship and its economic equilibrium, despite the fact that they do not form part of the text (or the four corners) of the contract.

Finally, the relational approach to treaty interpretation is also premised (in addition to mutuality) on dynamism, meaning the temporal dimension of the parties' relationship.[493] Because each party's understanding of the practices, usages, and interpretations of its counterparty necessarily evolves, as the relationship evolves, the content of the parties' obligations will necessarily also evolve, and will be defined by the parties' accumulated practice.

This evolution precludes the exclusive reliance upon traditional evidence of the intent of the parties at the time of ratification. Freezing the parties' obligations at the initial point

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[491] On the inclusiveness of the concept of legitimate expectations, see the analysis of the doctrine *supra*, in Part III. See also Sauvant, K. & Ünüvar, G. (2016), *Can host states have legitimate expectations?,* Retrieved from: http://ccsi.columbia.edu/files/2013/10/No-183-Sauvant-and-%C3%9Cn%C3%BCvar-FINAL.pdf

[492] Gottlieb, G. (1983), Relationalism: Legal Theory for a Relational Society, Chicago Law Review, 50 (2): 567, at 568.

[493] See Gottlieb, G. *supra* note 455, at 569.

of contracting does not allow for an accurate evaluation of dynamic obligations, which have to be defined also in light of the subsequent practice of the parties.[494] Nevertheless, such dynamic rationale stands in stark contrast with the static interpretation that arbitral tribunals have often given to the doctrine of "legitimate expectations".

The dynamic, evolutionary interpretation of treaties is not a novel concept. On the contrary, it has been applied on multiple occasions, even in the context of treaties including less vague and dynamic obligations than hybrid, investment treaties do. For example, the ICJ engaged in a dynamic interpretation of the treaty between Costa Rica and Nicaragua granting navigational rights on the river of San Juan, in order to issue its judgment on the *Costa Rica v. Nicaragua* dispute.

Taking issue with Nicaragua's argument that interpretation should be based on the 1858 meaning of the word "commerce" and not the 2009 meaning of the term, the Court held that, where the parties have used generic terms in a treaty, they had necessarily been aware that the meaning of such terms would evolve over time. The ICJ thus concluded that the disputed term must be interpreted as to have the meaning that it bears "on each occasion on which the treaty is to be applied", and not necessarily its original meaning.[495]

Last, apart from dynamism and mutuality as the interpretative axes of the parties' legal obligations, the relational approach rests also on the extra-legal premise of reputation. In the game of international relations, the number of players is small. The small number of states enhances the importance of reputation as a limiting factor upon state actions, as states that frustrate general expectations of compliance with international obligations risk losing the benefits of international cooperation.[496]

In principle, this reputational limitation does not apply to the large number of individual economic actors that have plenty of business opportunities in the domestic contractual

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[494] In the international context, the subsequent practice of the parties has been consistently relied upon by international tribunals to give current meaning to older agreements. See McGinley, D. (1985), *Practice as a Guide to Treaty Interpretation*, Fletcher Forum 9: 211.

[495] Dispute regarding Navigational and Related Rights (*Costa Rica v. Nicaragua*), Judgment, I.C.J. Reports 2009, at 213, paras 70-71. The assumption on evolutionary treaty interpretation holds also for the establishment of administrative commissions in trade and investment treaties. If the meaning of the treaty standards was to be interpreted in an evolutionary manner, the use of such commissions as a mechanism for treaty interpretation would be redundant. The WTO adjudicatory bodies have also engaged in evolutionary interpretation, *inter alia*, in the *United States-Shrimp* and the *China-Publications and Audiovisuals* cases. See United States – Import Prohibition of Certain Shrimp and Shrimp Products WT/DS58/23, Appellate Body Report and Panel Report pursuant to Article 21.5 of the DSU, 26 November 2001, and China-Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products, WT/DS363/R, Report of the Panel, 12 August 2009.

[496] Axelrod, R. (1986), *An Evolutionary Approach to Norms*, The American Political Science Review, 80 (4): 1095.

context.[497] However, the analogy can still hold in the field of concession contracts, where the number of big companies dominating the market is very limited (even more limited than the number of states). As a result, a more balanced system of dispute resolution taking into account the reputational constraints not only of the host states but also of the concessionaires, can exert substantial pressure on both actors to behave in a cooperative, good-faith way that curbs their potential appetite to engage in opportunistic hold up of and rent extraction from their counterparties.

[497] Smith, E., *supra* note 397, at 1589.

1. The different interpretative approaches

This chapter explores the applicability of relational contract theory to investment treaties in particular. Before examining the modalities of its application as an interpretative method, this section gives an overview of the different interpretative approaches proposed so far. The purpose is to show the evolution of investment-treaty interpretation from the more static and monocular, investors-right approach to the common-law approach, which comes closer to the relational contract law methodology.

a) The investors' rights approach

The first generation of interpretative methods for investment treaties took a private-law approach heavily focused on the rights of the foreign investor, as well as their nature and effect on determining the content of state responsibility. A strand of the literature has examined investors' rights through the models of direct rights (akin to human rights), beneficiary rights, and agency. Another perspective holds that the ILC Articles on State Responsibility are flexible enough to leave the determination of the nature of the investors' individual rights to the particular primary rules.[498] For others, the nature of treaty obligations or, in reverse, of investors' rights, is strongly connected to the hybrid, public-private nature of international investment treaties.[499] Yet another approach has gone even further in terms of the protection of foreign investors by supporting the evolving formation of an international common law of investors' rights.[500]

Even within the genre of "direct individual rights", scholarly views have diverged on their nature. Some have maintained that investors' rights are akin to human rights, finding support in the ILC Draft Articles on Responsibility of States for Internationally Wrongful Acts. Article 33 of the Draft Articles makes explicit reference to the possibility of the international responsibility of the state accruing directly to any person or entity other than the state, but delegates to the primary rules the determination of whether and to

[498] Crawford, J. (2002), The ILC Articles on Responsibility of States for Internationally Wrongful Acts: A Retrospect, The American Journal of International Law, 96 (4): 874, at 887-888.
[499] See, *inter alia*, Douglas, Z. (2003), *supra* note The Hybrid Foundations of Investment Treaty Arbitration, and Roberts, A., *supra* note 62.
[500] Porterfield, M. (2006), An International Common Law of Investor Rights?, University of Pennsylvania Journal of International Law, 27 (1): 79.

what extent persons or entities other than states are entitled to invoke responsibility on their own account.[501]

The Commentary 4 to the Article clarifies that, in case the primary obligation is owed to a non-state entity, it may be that some procedure is available whereby that entity can invoke the responsibility on its own account and without the intermediation of any State. Two examples are cited in this regard, the first are rights established for individuals by human-rights treaties, and the other rights created under bilateral or regional investment-protection treaties.

The approximation of investors' rights to human rights has also been maintained in case law. Taking a dis-integrationist approach to the contract-treaty relationship, *SGS v. Philippines* held that an investor cannot abrogate by contract its rights or dispense with the performance of obligations imposed on States by the international law of investment treaties. In this sense, the decision took also a public-interest approach stating that, although under international modern law treaties may confer rights on individuals, they will do so in order to achieve some public interest,[502] thus showing the blurred line between public and private in international investment law.

Douglas also proposes to discard the dichotomy between public and private international law and to investigate instead the different categories of state responsibility arising from a breach of an international treaty conferring direct rights upon non-state actors, and likens investment treaties to the European Convention of Human Rights as establishing both a distinct system of secondary rules of state responsibility in recognition of the independent legal interest conferred to investors by these treaties. Others have addressed investors' rights as human rights but taken a more public-law approach by considering them part of "global constitutional law".[503]

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[501] Draft Articles on Responsibility of States for Internationally Wrongful Acts, with commentaries (2001), at 94-95.

[502] *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, Decision of the Tribunal on Objections to Jurisdiction, ICSID Case N° ARB/02/6, (29 January 2004), para 154. See also the *LaGrand* case before the ICJ (*LuCrand, Germany* v. *United States of America, Judgement, I. C.J. Reports 2001,* p. 466), paras 77-78, where the Court reasoned that the right of the individual to be informed without delay under Article 36, paragraph 1, of the Vienna Convention was not only an individual right, but had assumed the character of a human right.

[503] Peters, A. (2016), Beyond Human Rights: The Legal Status of the Individual in International Law, Cambridge University Press, at 257-307. See also Lagrange, E. (2016), Investors' Rights Short of Human Rights in a Constitutional Perspective, Retrieved from: http://voelkerrechtsblog.org/investors-rights-short-of-human-rights-in-a-constitutional-perspective/ & Peters, A. (2016), Part 2: Simple International rights, global constitutionalism, and scholarly methods, The rejoinder to comments on "Beyond Human Rights" continued, Retrieved from: http://voelkerrechtsblog.org/part-2-simple-international-rights-global-constitutionalism-and-scholarly-methods/

On the other hand, another strand of literature has stressed the antinomy between investors' rights and human rights. *Hirsch* argues that the two fields have followed divergent paths, and draws support for his position from the Report of the High Commissioner for Human Rights,[504] whereas *Kriebaum* supports the cross-fertilization between the two fields maintaining that investment tribunals and human rights courts have a common project: to foster the rule of law through the protection of the right to property, which is also a human right.[505] Similarly, the tribunal in *Suez v. Argentina* held that Argentina had to equally respect both human rights and investment-treaty obligations, which were not inconsistent or contradictory with each other, nor mutually exclusive.[506]

The direct-rights approach is also bifurcated between those advocating that investors are directly granted both substantive and procedural rights and those maintaining that investors are nothing but mere beneficiaries of the substantive rights laid down in the treaties, and are given only the procedural right to enforce them, thus acting like third party beneficiaries.[507] The differentiation evidently has implications for the role of arbitrators in interpreting these rights, as they have a stronger role if investors have the combined set of rights, having as a result the restriction of states to amend those rights as freely as if only the procedural rights belonged to the investors.[508]

On the other side of the scale stands the derivative-rights methodology giving predominance to the public-law approach. In his analysis of the hybrid foundations of investment treaty arbitration, *Douglas* refers to *Loewen* as the seminal case articulating a derivative scheme for understanding the investor's cause of action.[509] As the *Loewen* tribunal stated, "there is no warrant for transferring rules derived from private law into a field of international law where claimants are permitted for convenience to enforce what are in origin the rights of Party states." [510] According to the derivative model, investment treaties institutionalize and reinforce the system of diplomatic protection, meaning that

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[504] UN High Commissioner for Human Rights (2003), *Human rights, trade and investment: report of the High Commissioner for Human Rights,* Retrieved from: http://repository.un.org/handle/11176/340519?show=full

[505] Kriebaum, U. (2013), *Aligning Human Rights and Investment Protection, Foreign Investments & Human Rights – The Actors and their Different Roles*, Retrieved from: http://opiniojuris.org/wp-content/uploads/tdm-v10-01.pdf

[506] See *Suez v. Argentina supra* note, para 240.

[507] Roberts, A., *supra* note 62.

[508] Roberts, A. (2015), *Triangular Treaties: The Extent and Limits of Investment Treaty Rights*, Harvard International Law Journal, 56 (2): 353. See *also Roberts, A. (2010), Power and Persuasion in Investment Treaty Interpretation: The Dual Role of States*, American Journal of International Law, 104 (2): 179, at 202, 214-5.

[509] *Loewen Group, Inc. & Raymond L. Loewen v. United States of America*, Award, ICSID Case No. ARB.(AF)/98/3, 26 June 2003.

[510] Id., para 233.

the substantive treaty obligations are owed to the contracting parties, which delegate to their investors only the enforcement of those obligations before international arbitral tribunals.[511]

Douglas concludes that both models are possible under international legal theory. International law does not prevent states from delegating to an individual their procedural right to bring a claim of diplomatic protection to enforce substantive rights enshrined in a treaty. Equally possible is, on the other hand, that an international treaty confers rights directly upon individuals, whether or not such rights are classified as human rights, as confirmed with the *LaGrand case*.[512]

Leaving aside the debate on the nature of investors' rights as derivative or direct, of particular relevance herein is *Douglas'* analysis on the nature of investment arbitration and the web of rules that investment treaties have created. Two elements merit special attention due to their implications for the argument made herein. The first is the argument that the strict distinction between public and private, as well as between treaty and contract, fails to depict the unique, "hybrid" nature of international investment law. On the contrary, as *Douglas* argues, the "international" or "treaty" and the "municipal" or "contract" spheres are "inseparably linked" with each other, as investment disputes are significantly concerned with issues pertaining to the existence, nature, and scope of the private interests comprising the investment.[513]

The second element is the observation that investment treaties do not explicitly specify the actual beneficiary of the substantive rights that they incorporate, nor do they address the status of investor-state arbitral tribunals. This lack of clarity, in combination with the inconclusiveness of the object and purpose of investment treaties, leaves room for interpretative maneuvers by resorting to the additional evidentiary sources of Article 31(3) of the Vienna Convention on the Law of Treaties, in particular the subsequent practice in applying the treaty.

The author points to the limits of the traditional interpretative rules of the VCLT in this regard.[514] He notes that investment treaties have created a web of uncodified rules generated by the subsequent practice regarding the application of the treaty. Unlike the traditional rule of the VCLT, which limit subsequent practices only between the actual

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[511] See *supra* Douglas, Z. (2004), The Hybrid Foundations of Investment Treaty Arbitration, at 163.
[512] Id., at 168. See *LaGrand* case *supra* note (Germany v. United States of America), 27 June 2001, ICJ Reports 2001.
[513] Id., at 154-155.
[514] *Douglas* is not alone in pointing to the interpretative limits of the VCTL for the purposes of interpreting the short and vague standards included in BITs. See, *inter alia*, *supra* Roberts, A., at 51. Several arbitrators have also expressed their struggling with giving content to the vague standard of fair and equitable treatment, as has been, for example, the case with the *Aguas Argentinas* dispute (to be examined below). The limits of the traditional rules of the VCLT will be further analyzed in following sections.

contracting parties-states, the interpretation of investment treaties requires taking into account a wider set of actors involved. In particular, arbitrators play a prominent role in the formulation of such subsequent practice through their decision-making powers and the emerging role of precedent in investment arbitration.

b) The public law approach

The public law approach departs from the monocular focus on the investors' rights and moves closer to the relational proxy of mutuality by advocating for a better balance between public and private interests through the application of general principles of administrative law in investment arbitration. *Schill* is one of the pioneers of the comparative public law approach, arguing that international investment law does not simply purport to back up private ordering between investors and states, but has a broader function in establishing principles of investment protection under international law. Investment arbitration is thus a mechanism not only for resolving individual disputes but also for implementing those principles. Considering institutional reform unlikely, he considers comparative public law the proper method for concretizing and legitimating the treaty standards, thus increasing the accountability and legitimacy of international investment law.[515]

The public-law approach consists, in particular, of two building blocks: the first one rests on the assumption of the unequal position of the parties, with the foreign investor being in a vulnerable position, exposed to the sovereign powers of the host state. The second refers to the dimension of investment arbitration as global governance, meaning the quasi-constitutional effect of arbitral awards that go beyond the resolution of individual disputes and affect the expectations of future parties, especially through the non-binding, yet persuasive system of "precedent".[516] The future impact of arbitral awards through the gradual formation of "precedent" indicates the importance of the proxy of dynamism in the interpretation of investment treaties.

As regards the operationalization of the public-law approach, *Schill* proposes a comparative public law methodology. For example, conceptualizing the fair and equitable treatment standard as an embodiment of the rule of law mainly relies - *Schill* argues - on this methodology, and specifically on taking a horizontal view of the various restrictions of governmental authority that are in place in different domestic legal systems embracing the rule of law. As a result, the appropriate methodology for concretizing FET is a

[515] Schill, S. (2010), *International Investment Law and Comparative Public Law*, Oxford Scholarship Online, at 2.
[516] Id, at 13-14.

comparative-law methodology that attempts to extract general principles of public law from domestic and international legal regimes endorsing the rule of law in the exercise of public power.[517]

The present thesis takes issue with the absolute perspective of the public-law approach considering investors to be in an inferior position than that of the host state. On the contrary, at least for the particular category of disputes arising from concession contracts, both the theory of transaction cost economics and the empirical data on the renegotiation of concession contracts described above show that it is not only the host state but also (and even more often) the concessionaire that initiates a contractual renegotiation. On the other hand, it sees merit in the identification of general principles of law and their application to interpret the vague investment-treaty standards, but does not restrict the source of such principles to public law, following instead the more open and inductive, common-law approach.

c) *The common law approach*

i) Overview

Unlike the direct versus derivate rights debate, the common-law approach moves the focus away from the question on the nature of the treaty rights bestowed to investors (and, conversely, those rights allegedly retained by states), and places the emphasis on the decision making powers of international arbitrators. In this sense, it takes a pragmatic, legal-realist approach to investment law, by making the observation that, in practice, arbitrators have assumed an indisputable role in interpreting the investors' rights under the open and vague standards contained in investment treaties, and have evolved into powerful lawmakers at the global stage.

In the origins of the common law approach lie two facts: the critical mass of investor-state arbitral awards and the doctrinal divergence in their formation. As *Sourgens* notes, the critical mass of arbitral awards does not have simply quantitative but also qualitative implications. The emerging development of a "jurisprudence constante" [518] is the result of numerous interrelated decisions forming an unexpected network of relatively uniform results despite the facial differences in consent instruments and the substantive standards of protection on which the awards are based.

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[517] Schill, S. (2010), *Fair and Equitable Treatment, the Rule of Law, and Comparative Public Law*, Oxford Scholarship Online, at 4.

[518] On the impact of investor-state arbitration on the formation of an emerging global regime for investment, see *supra* Salacuse, J. (2010), The Emerging Global Regime for Investment.

In this way, the quantity of awards has a direct bearing on their quality and the substance of the investor-state dispute settlement system as a whole. This interconnection between quantity and quality - *Sourgens* adds - suggests that there is "a *process* of construction beneath the mass of decisions generated by investor-state tribunals", and that "determining the rules of this *novel process* is important for, if not constitutive of, the growth of investor-state arbitration." [519]

The usual convergence in the results that this web of arbitral awards has produced is contrasted by the doctrinal divergence in the different explanations of the theoretical underpinnings of international investment arbitration and its (lack of) legitimacy. *Roberts* observes that the clash of the various explanatory paradigms is such that the investment treaty system has proven as problematic to classify as a platypus.[520]

In a similar vein, *Sourgens* broadly detects four ideological camps:[521] the first is the one of orthodox critics that see investor-state arbitration as usurping general international law for corporate gain.[522] The second camp sees investor-state dispute settlement as a quasi-contractual branch forming part of commercial arbitration or the *lex mercatoria*.[523] The third school advocates for the existence of a customary international law of the treatment of aliens due to the expansion of the "network" of bilateral investment treaties that have created a new custom mirrored in investor-state jurisprudence.[524] Last, there is the aforementioned public-law approach, which holds that international investment law serves a constitutional function for the emerging global economy, and should be reformed from within based on general principles of administrative law.[525]

According to the common law perspective, these four approaches fail to conceive the actual nature of investment arbitration and justify its legitimacy, because they conflate the ontological with the normative, in other words, they address the question of what investment arbitration "is" by explaining their position on what investment arbitration "ought to be".

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[519] Sourgens, F. (2014), A Nascent Common Law, The Process of Decision-making in International Legal Disputes between States and Foreign Investors, Brill, at 16. Emphasis added.
[520] See Roberts, A., *supra* note 62, at 57.
[521] See Sourgens, F., *supra* note 494, at 21.
[522] On the absence of sufficient standards of corporate governance, see Sornarajah, M. (2004), *The International Law on Foreign Investment,* Cambridge University Press, at 183.
[523] On the application of trade usage and commercial norms, and in particular the UNIDROIT Principles of International Commercial Contracts, to the standard of compensation for expropriation, see Park, W. (2002), *Income Tax Treaty Arbitration*, George Mason Law Review, 10 (4): 803, at 833-4.
[524] See, *inter alia*, Alvarez, J. (2009), *A BIT on Custom*, NYU Journal of International Law and Politics, 42: 17.
[525] See Schill, S. (2009), *The Multilateralization of International Investment Law*, The European Journal of International Law, 22 (1): 303.

In this sense, the weakness of the above doctrines lies in their selection of a normative criterion "external" to the arbitral practice, in order to support certain value prescriptions for the reform of the system, which can only be contradicted by alternative value prescriptions proposed by the rival camps. Thus, the risk of the normative focus of the various camps is that they lapse into pure speculation giving rise to debates fostering more dogmatic contributions than insightful commentary,[526] or they become tautological by presuming too much of what they purport to prove.[527]

Departing from the deductive, normative focus of the "four camps" the common law approach takes an "inductive" methodological approach to understanding and explaining investor-state arbitration. Instead of adopting a normative criterion of legitimacy, external to the practice of investment tribunals, it focuses on the "process" of decision making by arbitrators.

This focus on process means that the analysis of the "platypus" [528] focuses less on the end result, i.e. the award, and more on the "how", i.e. the process and the evidence leading to the award. Uncovering the decision-making process or the "operational code" [529] of arbitrators "through an inductive examination of the interpretative methods that they have deployed", is crucial for curing the legitimacy gaps in investment arbitration and, ultimately, making predictions about future awards. In the same way, uncovering the potential inconsistencies in interpretation can help put forward prescriptive solutions for the appropriate interpretative methods that arbitrators should deploy, at least with regard to particular classes of disputes.[530]

Two elements of the common law approach deserve praising herein: its "inductive" reasoning and its emphasis on the "operational code" of investment arbitration, that is, the "process" of arbitrators' decision-making. The process of decision making by arbitrators delegated with adjudicative authority at the international level shows that investment arbitration has the makings of global governance signaling a transition from an era of government to an era of governance.

"Governance" signifies the erosion of the boundaries between what falls within the ambit of government and its administration, and what lies outside of them.[531] In the case of international investment arbitration, private actors have the right to bring a claim directly

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[526] Sourgens, F., *supra* note 494, at 22-25.
[527] Koskenniemi, M. (2005), *From Apology to Utopia; Kennedy, D. (1987), The Sources of International Law*, Cambridge Books Online.
[528] See Roberts, A., *supra* note 62.
[529] See Sourgens, F., *supra* note 494, at 29.
[530] On the application of the differentiating methodology of transaction cost economics in international investment arbitration, see Maupin, J., *supra* note 67.
[531] Shapiro, M. (2001), *Administrative Law Unbounded: Reflections on Government and Governance*, Indiana Journal of Global Legal Studies, 8 (2): 369.

against a public actor, the host state, before private adjudicators called to apply public international law, in particular an international investment treaty. This hybrid configuration of investor-state relationships evidently calls for equally hybrid solutions in managing such a unique public-private international regime, which are represented neither by the private-law nor by the public-law approaches alone.

The extensive decision-making powers of arbitrators have triggered responses on how to control their quasi-legislative functions. *Yackee* frames investment arbitration as an agency to which the states, as principals, have delegated the authority to make important policy decisions. In sync with the new public contracting and the relational contract approach,[532] the agency framework of international investment law refers to a horizontal network of international policy-making actors, much like concessionaires are at the domestic level. “Policymaking” is defined as the delegated authority to engage in expert-based decision-making that leads to the articulation of rules and standards aimed at promoting a collective goal, namely the promotion of foreign investment.[533]

The agency framework goes even further than *Van Harten’s* and *Loughlin’s* global administrative law framework in that it recognizes that arbitrators do not simply apply treaty rules to review governmental actions, but also produce novel legal rules in their adjudicative capacity. What it shares, on the other hand, with the administrative-law perspective is the call for ensuring the control and the accountability of arbitrators as agents, especially as they engage in all the more complex, value-balancing exercises. It also departs from the constitutional approach in that it disagrees with placing investment tribunals at the peak of the international legal hierarchy. On the contrary, the agency argument is that arbitrators exercise delegated authority on behalf of their legitimate political masters, the states.[534]

ii) Delegation of interpretative authority and control mechanisms

The delegation of authority to arbitrators begs the question of their control and accountability. This is because international law - and even more so, investment law - presents an additional level of complexity, because delegating the authority to enforcement organs to create proxies is less straightforward than the equivalent delegation in a private-ordering setting. The international tribunals, which this authority is delegated to, tend to be less institutionally developed, and have a poorer track record

[532] See *supra* Vincent-Jones (2006), *The New Public Contracting: Regulation, Responsiveness, Relationality*.
[533] Yackee, J. (2012), Controlling the International Investment Law Agency, Harvard International Law Journal, 53 (2): 392, at 397.
[534] Id., 399.

than the domestic courts interpreting and applying the standards found in private contracts.

As a result, a state may have less confidence in the enforcer's ability to come up with satisfactory "proxies" - for example, the proxy of "legitimate expectations" to interpret and apply the standard of fair and equitable treatment. Consequently, formal enforcement of international-law standards, as opposed to rules, presents greater challenges than the use of standards in private contracts does.[535]

There are several perspectives and mechanisms of control of international arbitrators. According to *Grant's* and *Keohane's* principal-agent model of international institutions, sanctions and the threat of *ex post* punishment, or the *ex-ante* influence of agency's outputs, especially through the exercise of veto, can serve to control the delegation of power to the agents.[536] Such a severe interference with the decision-making authority of arbitrators would evidently risk, though, defeating the fundamental purpose of arbitration, which is the de-politicization of investor-state disputes.

Another proposal has been the better drafting of investment-treaty standards. Nevertheless, the risk with this approach is that vague terms open to interpretative fiat will be replaced by equally broad terms that would only achieve to move the locus of interpretative ambiguity to a different standard than the original one. It remains to be seen whether the description of FET in the CETA really exhausts all the contingencies of what can constitute a breach of the fair and equitable treatment obligation. Despite the enumeration of the (somehow) more concrete instances of breach of FET in paragraph 2 of Article 8.10, the CETA inserts officially the vaguer concept of legitimate expectations in its text. It thus sanctions the relevant jurisprudence that arbitrators had already created by deploying interpretative fiat in creating the "proxy" of legitimate expectations, resembling in this sense the decision-making authority of common-law judges.

Another mechanism - this time, procedural - that CETA deploys to constrain the adjudicative power of arbitrators is what *van Aaken* calls the use of "joint administrative commissions". Paragraph 3 of the FET Article stipulates that the parties shall regularly, or upon the request of a party, review the content of the obligation to provide fair and equitable treatment through a Joint Committee vested with decision-making powers on many occasions under the treaty. The need of such committees for reviewing the content of the standard on a regular basis attests to the validity of the argument made herein, i.e. that treaty provisions, and especially FET, are inherently incomplete and dynamic standards calling for an equally dynamic interpretation. The question that remains,

[535] See *supra* Scott, R. & Stephan, P. (2006), *Lessons from Contract Theory*, at 60.
[536] Grant, R. & Keohane, R. (2005), Accountability and Abuses in World Politics, American Political Science Review, 99 (1): 29.

though, is whether the procedural tool of administrative commissions is the proper method for achieving such dynamic interpretation.

The evident risk of assigning the interpretative authority to joint commissions, even more so on a regular basis, is the undermining of the very roots of international investment arbitration, i.e. the de-politicization of the settlement of disputes between states and foreign investors. States that, on the one hand, delegate interpretative authority to arbitrators and, on the other hand, interfere with the interpretative process, thus withdrawing such delegation, run the risk of sending a signal of political opportunism.

This is due to the potential lack of credibility of commitment,[537] and the sub-problem of time consistency, meaning a situation wherein a decision-maker's preferences change over time in such a way that a preference at one point in time is inconsistent with a preference at another point in time.[538] Moreover, as political economy predicts, politicians' change of preferences is not always an attempt to maximize national welfare, but often a rational act to maximize their chances of re-election.

For example, much like a populist government would attack free trade to resonate with the vested interests of the domestic industry, in a similar way the domestic industry has an incentive to lobby for barriers to investment. This increases the likelihood of some regulation being opportunistic, if it is the result of maximizing political support from certain FDI-hostile groups. If the contracting parties can also interfere with the interpretation of the treaty standards, it is evident that the only source of independent judgment of a violation of the treaty would give its place to the full politicization of disputes between states and foreign investors, thus defeating the very purpose for which the system of international investment arbitration was established.[539]

There are two types of safeguards against the problems of time-inconsistency and lack of credibility of commitment. The first is the independence of the incumbent administrative commission from the government (which is not the case of CETA, where the Minister of International Trade co-presides over the Joint Committee). The second is a rather

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[537] On the necessity of "credible commitments" for supporting "exchange", see *supra* Williamson, O., "Credible Commitments".

[538] Van Aaken, A. (2015), *Delegating Interpretative Authority in Investment Treaties*, in: Kalicki, J. & Joubin Bret, A., Reshaping the Investor-State Dispute Settlement System, Journeys for the 21st Century, Brill, at 36-37.

[539] The *ex post* interference of the contracting states with the interpretation of treaty standards, particularly FET, in all types of disputes across the board, is different from the case of *ex ante* carve-outs in specific domains. The mechanism of carve-outs aims to obviate the delegation of certain matters to tribunals in the first place. Examples of such institutional innovation are the Canadian FIPA 2004 and the US Model BIT 2012. Both models retain the interpretation of certain questions, deemed politically sensitive, for the respective agencies of the contracting states. From a contract-theory perspective, the contracting states in these cases withdraw the resolution of certain matters from the competence of the arbitral tribunal *ex ante*, and delegate such competence to their specialized agencies instead.

procedural safeguard referring to a specialized committee dependent on the government, but with technical expertise over a subject matter. Supposedly in this case the political and administrative dependence of the joint commission is balanced by the credibility of its expertise.[540]

Neither of those safeguards seems to resolve the question on the impact that state intervention risks having on the status of ongoing cases. Noting that the NAFTA Free Trade Commission's (herein, FTC) interpretation of the FET standard had an impact on pending cases,[541] *Kaufmann-Kohler* has enquired about the effects of the FTC's interpretative powers on the rule of law. She has observed in this regard that, whereas such institutional powers *in abstracto* can increase legal predictability, their exercise *in concreto* risks undermining the rule of law, for example, by violating the principle of retroactivity and the principle that no one may be the judge of their own cause.[542]

In any case, even when safeguards are put in place to control for potential political opportunism through interference with the adjudicative process, the situation remains that treaty provisions, namely FET, ultimately remain open-textured and open-ended "standards" subject to dynamic and evolutionary interpretation. As the example of the CETA model shows, the very fact that the contracting parties are expected to meet regularly to review the interpretation of the treaty, points precisely to the vagueness and open-endedness of the standards included therein.

iii) Precedent

It ensues from the above that the delegation of adjudicative authority to arbitrators remains broad (even if time-constrained, in case of the institutionalization of the subsequent intervention by the contracting states), as arbitrators are called upon to judge on inherently incomplete standards. Besides, it is noteworthy that not only investors but also states themselves resort to arbitration to establish the proper interpretation of a treaty term, as was the case with the *Chevron* dispute between Ecuador and the US.[543] As a result, arbitrators are in a position similar to that of common-law judges creating jurisprudence through case-by-case adjudication. In this context, it is evident that "precedent" can play an important role in disciplining the quasi-legislative power of arbitrators and increasing the predictability of their decisions.

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[540] See *supra* Van Aaken, A. (2015), at 37-38, 43.
[541] Namely, *Pope & Talbot*, *Mondev*, *ADF*, *Waste Management*, *Methanex*, and *UPS*.
[542] Kaufmann-Kohler, G. (2011), *Interpretive Powers of the Free Trade Commission and the Rule of Law*, in: Gaillard, E. & Bachand, F. (Eds.), *Fifteen Years of NAFTA Chapter 11 Arbitration*, International Arbitration Institute Series on International Arbitration, 7.
[543] http://www.pca.cpa.org/showpage.asp?pag_id=1455

Despite the fact that arbitration operates outside of any hierarchically organized court system, and is based instead on tribunals appointed to judge *ad hoc* disputes, it would be ostrich to ignore the common references that arbitrators make to previous cases, when called to interpret the vague treaty standards in dispute. This (often informal) dialogue between arbitrators, and the ensuing, evolving formation of an arbitral epistemic community begs the question what a "doctrine of precedent" would mean in the context of investor-state dispute settlement.

Indeed, *Kaufmann-Kohler* has observed that, despite the lack in international arbitration of a formal doctrine of precedent - at least as is known in the common-law system - arbitrators refer increasingly to earlier cases. She summarizes arbitral practice in this regard citing a quotation from *El Paso v. Argentina* reading that: "ICSID arbitral tribunals are established *ad hoc*, […] and the present Tribunal knows of no provision, […] establishing an obligation of *stare decisis*. It is nonetheless a reasonable assumption that international arbitral tribunals, notably those established within the ICSID system, will generally take account of the precedents established by other arbitration organs, especially those set by other international tribunals." [544]

Fernández Arroyo makes the point that arbitral case law differs from judicial case law, highlighting that, in the context of international arbitration, there is no clear distinction between common and civil law systems but a unique combination of both systems. Examining arbitration laws, international conventions on arbitration, and arbitration rules, he concludes with the legal-realist observation that, despite the inexistence of an express and formal legal duty to follow precedents, the "practice" in the field of investment arbitration has been to refer to earlier awards, as well as decisions of other international bodies, especially the International Court of Justice.[545]

In short, all the aforementioned elements of the system of international investment arbitration, namely the delegation of decision-making authority to arbitrators to interpret broad and vague treaty standards, and the emerging doctrine of precedent (albeit different from the traditional precedent in domestic law) point to the nature of international investment law as common law in the making.

The mechanisms for controlling the investment-law agency are welcome but cannot substitute for the interpretative powers of arbitrators, who continue to maintain

[544] *El Paso Energy International Co.* vs. *Argentine Republic*, *supra* note ICSID Case ARB/03/15, Decision on Jurisdiction, 27 April 2006, para. 39. See also Kaufmann-Kohler, G. (2006), *Arbitral Precedent: Dream, Necessity, or Excuse?*, Retrieved from: http://www.arbitration-icca.org/media/4/77507134886347/media012319143087130009500001.pdf, at 368-369.

[545] Fernández Arroyo, D. (2014), *Private Adjudication Without Precedent?* in: Watt, H.M. & Fernández Arroyo, D. (Eds), *Private International Law and Global Governance*, Oxford Scholarship Online, at 128-129.

significant leeway in interpreting and applying inherently incomplete and vague treaty provisions that are always "standards" and not "rules". Besides, it would increase prohibitively the transaction costs of adjudication (thus decreasing, in reverse, the efficiency of international investment arbitration) if states were to step in on every single occasion when they would disagree with an arbitral decision or the interpretation of a treaty standard.

Under the umbrella of the aforementioned "credible commitments" that investment treaties aim to create,[546] international investment law has to achieve a balance between commitment and flexibility.[547] Such a balance can be achieved through the use of the "proper interpretative methods" by arbitral tribunals. Being internal to the adjudicatory system of investment arbitration, such interpretative mechanisms stand a better chance of producing more realistic and sustainable results for all the parties involved, thus making interpretation a central pillar of the common-law approach, given the wide decision-making authority that arbitrators are vested with.

Similarly, interpretation can be part of the solution to the cacophony of the fragmentation of international law.[548] Through the consistent use of the proper method and the ensuing development of precedent, treaty interpretation may offer "shared hermeneutics" in search of a more systemic integration of diverse treaties and tribunals, and inject a degree of coherence into the fragmented landscape of international law.[549]

In addition to its potential for reforming the system "from within" (thus offering more pragmatic and sustainable solutions taking stock of the "actual practices" of arbitral tribunals) the common-law approach also has the merit of recognizing the reality of the blurred distinction between the public and private spheres. Although investor-state arbitration certainly does not go as far as the *lex mercatoria*, and what *Teubner* calls "a global law without a state",[550] elements of the *lex mercatoria* exist not only in commercial but also in investment arbitration.[551] In an attempt to address this thin line between the two domains, *Van Harten* proposes an analytical framework for

[546] On the importance of "credible commitments" as a reason why states sign IIAs, see the seminal article by Guzman, A. (1998), *Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, Virginia Journal of International Law, 38: 639.
[547] Van Aaken, A. (2009), *supra* note *International Investment Law between Commitment and Flexibility: A Contract Theory Analysis,* Journal of International Economic Law, 12 (2): 507, at 10
[548] Crema, L. (2010), *Disappearance and New Sightings of Restrictive Interpretation(s),* The European Journal of International Law, 21 (3): 681.
[549] Bianchi, A. (2010), Textual Interpretation and (International) Law Reading: The Myth of (In)determinacy and the Genealogy of Meaning, in: (Eds) Bekker, P. Dolzer, R. & Waibel, M., Making Transnational law Work in the Global Economy: Essays in Honour of Detlev Vagts, Cambridge University Press.
[550] Teubner, G. (1997), *supra* note 321 "Global Bukowina": Legal Pluralism in the World Society, Global Law Without a State, Ashgate Publishing Company.
[551] See *supra* Chapter II, section on UNIDROIT.

distinguishing public from private by relying on the assessment of the character of the relevant acts of the State.[552]

The present thesis endorses the distinction between different categories of state acts, and follows a similar reasoning with *Maupin's* aforementioned differentiation of investment disputes, but also argues that in the context of such a hybrid, public-private system the decision-making authorities of states and arbitrators are inextricably linked. This does not mean of course that states should leave the arbitrators' delegated authority uncontrolled. Such control, though, should rather focus on the "process" of decision making (including the potential establishment of a multilateral investment court), and not interfere with the arbitral interpretation of treaty standards and thus the independent and depoliticized adjudication of investor-state disputes.

iv) Criticism and value

The current thesis uses the potential of the common-law approach for reforming the system of investor-state dispute settlement by simultaneously departing from what it considers its downsides, namely the increased focus on investors' rights. To this end, it focuses on two specific elements: the perspective of law as "process" - in particular, a process for the interpretation of vague standards - and the adoption of "inductive reasoning" as a driver for a pragmatic, legal-realist reform of the system.

The emphasis on "process" is particularly relevant in the context of treaty disputes arising from the renegotiation of concession contracts. As aforementioned, an element missing from the adjudication of such disputes, and especially the interpretation of FET therein, is the legal evaluation of the renegotiation process *per se*. According to the relational-contract argument made herein the process itself can draw the line between contractual renegotiations following due process and thus being compatible with international law (as long as the legal conditions of hardship, crystallized in the UNIDROIT Principles are fulfilled) and a forced renegotiation based on the unilateral exercised of sovereign power by the host state, thus not complying with the requirement for a fair and equitable treatment of the foreign investor. Similar emphasis on "process" gives the proposal for conducting renegotiation through mediation and for gathering "evidence" on the renegotiation in its entirety, including the process itself.

The second tenet of the common-law approach endorsed herein is its "inductive reasoning". Taking issue with the alternative theories on adjudication that either sanction

[552] Van Harten, G. (2007), *The public-private distinction in the international arbitration of individual claims against the state*, International & Comparative Law Quarterly, 56 (2): 371, at 372.

the protection of investor's property as part of customary international law, or completely discard investment arbitration as a corrupt tool for the corporate usurpation of international law, the common-law approach aligns itself more with the school of critical legal studies and legal realism by taking stock of the actual role that arbitrators have played so far in resolving investor-state disputes. This thesis adopts precisely the inductive approach in examining the case law that tribunals have produced when judging the alleged breach of FET due to the renegotiation of concession contracts, and categorizes the relevant awards in a matrix ranging from a classical-contract-theory approach to a relational-contract-theory interpretative methodology.

Another element, common in the relational-contract-theory and common-law approaches, is the rejection of the regime or network theory of BIT generation, i.e. the argument that international investment law constitutes a self-contained regime, hermetically isolated from other fields of (international) law. Siding with both approaches, the proposal made herein is that of a nascent common law based on relational-contract principles, in other words, a nascent, "relational common law".

In this context, "cross-fertilization" should come, (at least for the particular type of disputes arising from concession contracts) from the (equally nascent and evolving) field of contract law, and specifically relational contract law. The unique, hybrid interpretative framework of relational contract theory matches the equally unique and hybrid nature of international investment law, and in particular arbitration, and is thus more promising for achieving a better balance between the interests of the disputing parties.

2. Transcending the Public-Private Schism: The Contract Theory Approach

a) The hybrid nature of investment arbitration as a public-private regime

As aforementioned, investment arbitration does not fit within the strict contours of either private or public law, but instead bears characteristics of both fields thus constituting a unique, hybrid regime. Whereas the investors' rights and the public law approaches follow the dichotomy between private and public, the common law approach makes a first step to overcoming such polarization by taking a legal-realist perspective adopting elements from both fields. From private law (commercial arbitration in particular), it endorses the bottom-up, inductive reasoning, while with the public approach it shares its emphasis on process as a necessary component of delivering a just result in the resolution of a dispute.

There are already elements of the relational-contract approach in awards addressing the complex relationship between contract and treaty claims (as well as between domestic law and international law). The value of the divergence in the reasoning of the *SGS v. Pakistan* and *SGS v. the Philippines* tribunals lies particularly in what they see as the purpose of investment treaties. Endorsing the relational proxy of mutuality, the *Pakistan* tribunal reasoned that umbrella clauses "should be read in such a way as to enhance *mutuality* and balance of benefits in the inter-relation of different agreements located in differing legal orders",[553] and in order to avoid a clash between what it considered as two distinct bodies of law, i.e. the contract and the treaty. On the other hand, the tribunal in case against the Philippines distinguished between the scope and content of a state's contractual obligations and their performance, with only the latter being internationalized and brought under the ambit of an investment treaty, while the first is left to be defined by the domestic law of the host state.[554]

This thesis endorses elements from the reasoning of both tribunals, arguing both for the internationalization of the performance (including the renegotiation) of the contract and the "mutuality and balance of benefits in the inter-relation of different agreements located in differing legal orders". This means that the "internationalization" of the contract brings (or shall bring) both contractual parties within the realm of international law, while the mutuality of their contractual relationship entails the assumption by the investor not only of international rights but also of international obligations. In other words, a regulatory contract is brought under international law in its entirety, i.e. for the rights and obligations of both contracting parties. To this end, interpretative devices serve as "entry points" for investors' obligations under international investment treaties.[555]

Parting with the alleged distinction between public and private, this thesis also follows *Maupin*'s "integrated-systems" approach moving away from the categorical debate of public vs. private in international investment law, and towards the pragmatic question how the system actually works and how it can be improved. *Maupin* observes in this regard that the public-private divide has been deemed artificial already from the early 1900s, when legal realists and New-Deal theorists demonstrated its unworkability.[556]

[553] *SGS v. Pakistan*, *supra* note Case No. ARB/01/13, para 168. Emphasis added.
[554] *SGS v. Philippines*, *supra* note Case No. ARB/02/6, para 126.
[555] Spears, S. (2010), The Quest for Policy Space in a New Generation of International Investment Agreements, Journal of International Economic Law, 13 (4): 1037.
[556] Maupin, J. *supra* note 67, at 373. The artificiality of the public-private divide is even more salient in the era of the "Renew Deal" marking the further withdrawal of the state through the fall of regulation and the rise of governance. See *supra* Lobel, O., on the rise of the new public contracting, meaning the delegation by contract of public authority to the private sector.

b) *The Interpretation of Investment Treaties using Relational Contract Theory*

Restricting the discussion on treaty interpretation to the aforementioned "textualism vs. contextualism" debate does not suffice for the purposes of interpreting investment treaties. Using only the traditional rules of treaty interpretation, as depicted in the Vienna Convention on the Law of the Treaties (herein, VCLT), is not sufficient to achieve an accurate interpretation of hybrid, public-private instruments, as investment treaties are.

As *Wessel* notes, the conventional wisdom according to which all treaties are governed by the same interpretative rules and norms, namely those of the Vienna Convention, is misguided. On the contrary, treaties regulate situations of varying degrees of "interaction" between partners and vastly different "relationships", not subject to a one-size-fits-all interpretative methodology. The overarching relational-contract principle in this context is the "nature of the parties' "relationship". Courts cannot confine themselves to the "four-corners" of the Vienna Convention nor the treaty in dispute, but have to examine, instead, the "overall relationship" between the contracting parties.[557]

In the *sui generis* environment of investment treaties, this "relationship" is hybrid, meaning encompassing not only the (rare) interaction between the contracting states, as public actors, but also (and primarily) the recurrent and dynamic interactions between host states and foreign investors, as unconventional, yet increasingly important, private actors under international law. The traditional VCLT rules are not designed to cover this "private" part of investment treaties and the role of the investor in the application of the treaty standards.[558] It is this interpretative gap that the principles of relational contract theory proposed herein, aim to fill.

Following the discriminating methodology of transaction cost economics, the specific relationship in focus herein, which defines the interpretation of the overarching investment treaty, is the concession contract between the host state and the foreign investor. Endorsing this differentiation logic, *Maupin* highlights the heterogeneity of investor-state disputes by identifying three dimensions or continua along which the differing characteristics of disputes fall: the socio-legal, the territorial, and the political continua.

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[557] Wessel, J. (2004), Relational Contract Theory and Treaty Interpretation: End-Game Treaties vs. Dynamic Obligations, NYU Annual Survey of American Law 60 (1): 149.

[558] As *Alstine* has noted in the context of the UN Sales Convention, in light of the Convention's private sphere of application, the interpretative standards of the Vienna Convention on the Law of Treaties have little authoritative interpretative guidance to offer. This remark holds also for the private sphere of investment treaties, which is nevertheless linked to their public sphere, thus calling for genuinely hybrid, public-private methods of interpretation.

The first ranges from individual to societal and encapsulates the potential "externalities" that the dispute produces, while the territorial continuum varies from local to transnational, and illuminates the geographical breadth of a dispute, as defined by its actual and potential impact. Despite the absence of formal *stare decisis*, treaty-based decisions typically have extraterritorial legal salience. Last, the political continuum varies from commonplace to contested, and depicts how the award is perceived by constituencies having an interest in its resolution. Examples of highly politicized disputes are evidently those arising in strategic sectors, like energy infrastructure, or are based on a claim for breach of a broad and indeterminate treaty standard (namely FET), or arise in the context of an economic or political crisis.[559]

It is evident that treaty disputes arising from the renegotiation of concession contracts fall squarely into all three ends of the aforementioned spectra presenting the most salient externalities for non-contracting parties. In other words, such regulatory disputes are societal, transnational, and contested, as they involve sectors highly sensitive for the development of the host state and the protection of indispensable public goods.

Chen argues for the application of contract theory to regulatory disputes, observing, though, that investment tribunals have not taken advantage of the contract law's more sophisticated tools of interpretation.[560] He contends that the application of contractual principles to treaty interpretation is functionally superior to the public-law alternative, because it guides tribunals to resolve regulatory disputes on the basis of "legal principles" rather than policy judgments.[561]

To this end, *Chen* identifies specific contractual principles that can serve as interpretative compasses for investment treaties, all revolving around the "default" mechanism, as the main concept of contract theory. These principles are, in particular, the majoritarian default rule, and the default standard of changed circumstances, with the foreseeability and efficient risk bearer tests serving as proxies to identify its content.

By choosing to use in their treaties open-ended terms like fair and equitable treatment, the contracting parties delegate the authority to investment tribunals to develop the meaning of such standards. Given the limitations of the "text and purpose" rules of the Vienna Convention for determining the parties' "intent", the majoritarian default rule identifies such intent with what the majority of similarly situated parties would have wanted. The alleged core benefit of this methodology is its predictability and the decrease

[559] See Maupin, J., *supra* note 166, at 476-479.
[560] Chen, R. (2015), *A Contractual Approach to Investor-State Regulatory Disputes*, Yale Journal of International Law, 40 (2): 295, at 315.
[561] Id., at 299. In this sense, contract theory resembles the common-law approach, which advocates for an inductive and internal interpretative methodology instead of external methodologies substituting policy preferences and judgments for legal principles.

of the transaction costs of laying down in the treaty all the elements and possible contingencies of a standard.[562] Under the default majoritarian rule investors are not precluded from invoking unfair and inequitable treatment to challenge certain illegal acts of the host state, such as bad faith, coerciveness, and lack of due process. On the contrary, a mere departure of the state from regulatory stability would be outside of the scope of the FET standard.

Another contractual instrument common in investment treaties are default "standards". The vagueness of "standards" creates the need for "proxies" striking a balance between the competing objectives of regulatory flexibility and investment protection. In a contract-law analogy, the revision by a host state of its regulatory framework is akin to a change of circumstances altering the equilibrium of a contract. The question in this context is how changed circumstances can inform the content of the fair and equitable treatment standard.

Resonating the argument made above on the application of the UNIDROIT Principles on hardship as the legal standard for evaluating FET, *Chen* argues that the principles on contractual adaptation due to changed circumstances shall not be used in investment law as a "defense" excusing a breach of FET. On the contrary, their application would entail a low threshold of changed circumstances precluding a breach of FET "in the first place", instead of getting into the enquiry whether the (overly rigid) threshold requirements of the necessity defense under public international law have been met.[563]

The proxies that *Chen* uses to give content to the default standard of changed circumstances are "foreseeability" and the "efficient risk bearer" analysis. Regarding the foreseeability of the materialized risk, an indicator whether a contingency was envisioned is "the pricing of the risk into the contractual bargain" that the parties had struck. This indicator was used by the respondent in the *CMS v. Argentina* dispute, where Argentina argued that the investor had already been compensated for the riskier business environment in the host country "by factoring this risk into higher tariffs in their concession contract", compared to lower tariffs that the investor would have been offered in a more stable country.[564] This contractual perspective on "foreseeability" obviously

[562] As is the current trend of including elaborate definitions of legal standards in recent, very lengthy treaties, such as in the case of CETA and the fair and equitable treatment standard. Whether such detailed definition of standards transforms them into rules that will lead to reversely short awards remains to be seen (the prediction of the current thesis is that arbitrators will retain in practice a wide interpretative authority, which would then have to exercise in a responsible and "moral" way).
[563] As was the case with all the tribunals that decided the disputes that arose from the Argentine economic crisis, and the ensuing literature that focused on the defence of necessity under public international law, and the (overly rigid) threshold for reaching its requirements.
[564] Accepting both higher tariffs and the assumption of the all financial risks by the state would entail windfall profits for the concessionaire, which is a practice rejected by the tribunal in *Aminoil*. See *supra* Chapter I.

leads to different legal results compared to the quasi strict-liability approach that most arbitral tribunals adopted, based on the rigid necessity defense under public international law, as analyzed in the cases below.

Regarding FET in particular, a strong stability commitment is incompatible with the parties' need to adjust their relationship to unforeseeable (not just in terms of their likelihood *in abstracto*, but also their specific magnitude as materialized) events, such as an economic emergency.[565] Non-foreseeability should thus be measured against the information available at the time of contracting.[566] In this sense, a host state could address new problems not contemplated at the time the treaty entered into force. Such a lower bar for non-foreseeability would be a better approximation of the states' "intent," as the FET standard is by definition far more expansive than any simple private-law contract containing relatively concrete provisions. As a result, states cannot realistically price even relatively proximate contingencies into their treaty, given the vast scope and complexity of events states have to address on a rolling basis.[567]

The alternative proxy for imparting meaning to the default standard of changed circumstances is, according to economic theorists, the "efficient risk bearer" test, which allocates the risk of changed circumstances to the party in a better position to bear it, owed to her capability to better evaluate and insure against the disputed risk.[568] The criterion does not entail the automatic assignment of all commercial risks to the investor and all political risks to the state.

For example, the court in *Transatlantic Financing Corp. vs. United States* rejected the investor's defense reasoning that *Transatlantic* was not less able than the United States to purchase insurance to cover the occurrence of the invoked contingency. It added that, if anything, it is more reasonable to expect owners-operators to insure themselves against the risk of war.[569] One would question why this reasoning would apply against the investor in case of war (which is a more extreme contingency for an investor to insure against) and not in case of an economic crisis, which the investor could have insured

[565] The public-law approach takes a similar view with *Schill's* in particular in arguing that tribunals should allow for a certain flexibility for host states to react, for instance, to emergency situations. See Schill, S. (2010), *supra* note 491, at 151.

[566] Sirianni, S. (1981), *The Developing Law of Commercial Impracticability and Impossibility: Part I*, Uniform Commercial Code Law Journal, 14: 30, at 61-62. The (non-) availability of information is the argument commonly used by concessionaires to request a renegotiation of their contract shortly after its award through competitive bidding. For the sake of the equality of arms, it should be made available to host states as well when they invoke lack of awareness as to an overly expansive interpretation of FET, contrary to what they have envisioned when they signed the relevant treaty.

[567] See Chen, R. *supra* note 546, at 328.

[568] Id., at 330.

[569] *Transatlantic Financing Corp. vs. United States*, U.S. Court of Appeals for the District of Columbia Circuit 363 F-2d 312, 27 May 1966.

itself against (for example, by securing higher tariffs as a premium for the increased investment risk – as allegedly happened in the cases of the Argentine concession contracts examined below).

On the other hand, the state assumed the business risks that the investor had initially assumed (as part of its participation to the bidding process) in the *Suez v. Argentina* case.[570] As *Wells* has noted, "the original contract for *Aguas Argentinas* did not peg water prices to the dollar; pegging was one of the revisions that emerged from subsequent renegotiations." [571] Nevertheless, the only contract that formed part of the tribunal's inquiry into the claimed breach of FET was the last version of the renegotiated contract without taking into account any of its previous renegotiations, and the resulting shifting of rents between the parties during the evolution of their relationship.

If it is efficient to renegotiate a contract to alleviate the financial risks that the investor has willingly assumed, why would it not be equally efficient to renegotiate a contract to alleviate the host state from obligations too onerous for the consumers to honor in times of emergency or crisis? Moreover, one would wonder how much risk an investor actually assumes even during normal times, when its investment has been leveraged at a prohibitively high level, as was *inter alia* the case with *Aguas Argentinas*. In that case, the foreign investor had incurred such high levels of debt during the pre-crisis period that it proved impossible for it to find a domestic firm willing both to assume its debt and keep tariffs at a pre-crisis level.[572]

In addition to their contractual nature, investment treaties are also inherently incomplete contracts creating dynamic obligations. Whereas the VCLT norms are appropriate for interpreting "end-game" treaties establishing static obligations, relational contract principles are necessary for the interpretation of dynamic treaties establishing flexible and dynamic regimes aiming at preserving the parties' valuable relationships.[573] The traditional rules of treaty interpretation, as codified in Articles 31 and 32 of the Vienna Convention, sanction the textual, "ordinary-meaning" approach, in combination with the "teleological" approach used as an ancillary interpretative method. On the contrary, it discards the relational-contract approach seeking the actual "intent" of the parties, meant

[570] Despite the fact that, as opposed to the investor, the state does not have the option of portfolio diversification - In combination, optimally, with responsible project financing - especially lending - practices - as a risk-mitigation strategy.
[571] See *supra* Wells, L. (2010), *Backlash to Investment Arbitration: Three Causes*, at 346.
[572] See *supra* Post, A., at 236. The case can be opposed, for example, to the water privatization in Córdoba, where the concession was not as severely affected by the crisis as those concessionaires that had heavily indebted themselves to fund investment prior to the crisis. As a result of lower level of indebtedness, the firm's demands were more modest, and, consequently, the government was more disposed and able to work with the investor. Id., at 257.
[573] See Wessel, J., *supra* note 656, at 149-150.

in its broader sense as to encompass not only the "four corners" of their agreement but their overall, dynamic relationship.[574]

"Dynamic obligations", a term coined by *Edwin Smith* to depict the evolving nature of arms control agreements between the United States and the former Soviet Union,[575] correspond to *Macneil's* relational end of the contractual spectrum, which refers to "intertwined" contracts creating "repeated interactions" and the ensuing need for a "cooperative relationship" between the parties. The actual predictability of the implementation of such treaties is dependent upon the parties' "relationship", which the tribunal has to examine in order to determine the "intent" of the parties.

Other examples of dynamic treaties are sovereign debt agreements, which demonstrate several relational characteristics common with investment treaties: a "mutually dependent relationship" between a state (the sovereign borrower) and a private actor (the bank) and a similar interdependence between "domestic" (economy, in the case of sovereign debt agreements, and investment contract, in the case of investment treaties) and "international" (domestic being the borrower's economy, in the case of sovereign debt agreements, and the investment contract, in the case of investment treaties, and international being the banking system, in the former, and the foreign investor's operations, in the latter).

In summary, the main characteristics of dynamic obligations are the following: the treaty is of long-term duration (much like long-term contracts), and includes open terms (much like the vague FET standard), and transaction-specific investments (as predicted by the condition of "asset specificity" in transaction cost economics). In this context, a close relationship develops between the parties and their future cooperation becomes an indispensable part of successful treaty implementation.[576] All these propositions apply to investment treaties, which are indeed long-term contracts involving asset-specific foreign investments that require the parties' repeated interaction and cooperation for their implementation, and are protected by open, inherently incomplete, and vague standards.

Indeed, the necessity for an evolutionary interpretation of investment treaties results also from the "vagueness" of their standards, especially of FET, which means that the adjudicator can hardly rely on literal interpretation.[577] Characteristic were the remarks of the *Suez v. Argentina* tribunal that such "ordinary-meaning" interpretation of FET, for example some tribunals' reasoning that "fair and equitable" means "just", "even-handed", or "legitimate", only leads to tautological definitions, and that, on the contrary, another

[574] Id., at 162-163.
[575] See *supra* Smith.
[576] See supra Wessel, J., at 175-178.
[577] Gazzini, T. (2016), Interpretation of International Investment Treaties, Bloomsbury Publishing, at 91.

interpretative methodology is needed to operationalize the standard.[578] The conclusion is that, despite the minor variations in wording, as the tribunal in *Parkerings v. Lithuania* observed, textual treaty differences must not be overestimated and most wordings can be used interchangeably, and do not bear any substantial difference as to the content of the standard that investors are entitled to.[579]

Similarly, investment treaties are inherently incomplete contracts, as the contracting parties leave contractual gaps inadvertently, necessarily, or strategically open. States write incomplete and relational investment treaties due to the prohibitive *ex-ante* transaction costs of writing a complete contract (or treaty). This way the contracting parties economize on the "front-end" transaction costs but increase the "back-end" transaction costs, meaning the dispute-related costs, by delegating wider decision-making authority to arbitrators,[580] who are thus delegated not only with a dispute-settlement function, but also a gap-filling, norm-setting authority.

According to *Alschner*, the degree of incompleteness differs depending on whether the treaty is a first or a second generation bilateral investment treaty. The author notes that the "first generation" BITs (or, otherwise, the "OECD model") are highly incomplete contracts containing only brief and vague standards that delegate much of the gap-filling authority to tribunals. He contrasts this first model with the "second generation" BITs (or the "NAFTA model"), which are complex and comprehensive agreements employing a range of gap-filling alternatives to the option of delegating such quasi-legislative authority to the courts and arbitral tribunals.[581]

Alschner argues that the choice of the proper interpretative methodology depends on the degree of contractual incompleteness characterizing the disputed treaty. Whereas the first generation of highly incomplete treaties calls for the development of a *jurisprudence constante* (including by resorting to sources extraneous to the treaty text, especially general principles of law) the BIT-by-BIT, textual approach is more appropriate for the interpretation of NAFTA-like BITs.

Drawing from *Posner's* argumentation on the distribution of transaction costs between contract negotiation and contract adjudication,[582] *Alschner* likens interpretation to market intervention: if the contracting parties' own law-making works well, the courts should

[578] See *supra Suez v. Argentina*, paras 221-222.
[579] *Parkerings v. Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007, paras 276-278.
[580] Scott, R. & Triantis, G. (2005), *supra* note Anticipating Litigation in Contract Design, The Yale Law Journal, 115 (4), 814-879.
[581] Alschner, W. (2013), Interpreting investment treaties as incomplete contracts: Lessons from contract theory, Retrieved from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2241652, at 1, 3.
[582] Similar reasoning to *Posner's* is the reasoning of Scott and Triantis. See Scott, R. & Triantis, G., *supra* note 401.

defer to market outcomes and act as mere problem solvers, whereas, if markets do not work well and contractors fail to write complete contracts, courts assume the role of gap-filling and norm-setting actors.[583]

Despite the differentiation, in theory, between the two generations of treaties, the author admits that considering judicial norm-setting as a function of the contractual incompleteness of treaties is a prescriptive rather than descriptive assessment of the arbitral tribunals' behavior when interpreting and applying a treaty standard. He observes that arbitrators usually assume a high degree of uniformity among treaties and take recourse to "common principles" of the "global regime for investment". They also draw from different legal sources – not limited to the four corners of the treaty – in their interpretative endeavors (including previous case law, despite the formal absence of *stare decisis*) as well as from other extra-contractual norms.[584]

This thesis sides partly with *Alschner's* differentiation between first and second generation treaties, but emphasizes the argument that the divergence in interpretative methods as a parameter of contractual incompleteness only changes the "extent" and not the nature of the arbitrators' interpretative authority. Whereas for those instances where the contracting parties have drafted clear rules the tribunals will be more constrained by the text of such rules, their wide interpretative authority will remain indispensable for those provisions of investment treaties that are still formulated as vague standards rather than concrete rules.

It thus remains to be seen whether the so-called "second generation" investment treaties indeed alleviate the ambiguity of previous treaties or only remove the locus of such ambiguity from one vague term to another (in line with the predictions of contract theory and the reality of the prohibitive costs to write a complete, contingent contract, endorsed in this thesis). In any case, the question that remains valid under either scenario, is "how" the interpreters' "norm-setting" authority shall be exercised, or in other words, how arbitrators should select the appropriate interpretative "proxies" . As the text of the treaty itself does not offer any guidance on the selection of such proxies, tribunals can turn to contract theory, and especially its concept of "efficiency" as the appropriate benchmark for such selection.[585]

In the case of relational contracts "efficiency" is defined as the alignment of the parties' incentives and their cooperation to achieve the necessary adaptations of their contractual

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[583] See Alschner, W., *supra* note 171, at 13.
[584] The arbitrators' recourse to extra-contractual norms in order to interpret the treaty standards, instead of strictly limiting themselves to the text of the treaty, shows that they can be receptive to relational contract theory, which prescribes precisely taking into account contextualist norms in evaluating the implementation of a contract (or a treaty).
[585] See *supra* Alschner, W., at 15.

relationship, sharing both the burden and the surplus that such successful adaptations produce. As the main behavioral hazards putting at risk such a cooperative relationship and adaptive governance are bounded rationality and opportunism, the interpreter has to select proxies economizing on these transaction costs and aiming at preserving the parties' dynamic relationship. The specific proxies of relationality are "mutuality" and dynamism".

"Mutuality" serves to control for opportunism, as it puts the state and the investor in parity under international investment law, forcing the arbitrators to examine the conduct of both parties when evaluating whether there was a breach of a treaty standard, namely FET. This interpretative proxy can address the potential misalignment of the parties' incentives under domestic and international law, which can result from the investor's exclusive right of recourse to international arbitration and the risk of manipulating this mechanism to invalidate the relational character of its concession contract with the host state.

In other words, an investor that challenges the last contractual renegotiation as illegal under the treaty, despite having initiated previous renegotiations under the domestic law of the host state, acts opportunistically in that it transforms a relational contract, under domestic law, into a classical contract, under international law. By applying the relational proxy of mutuality in interpreting FET, the arbitrator deters such opportunistic behavior as she looks into the all renegotiations that have taken place and evaluates the behavior of both parties throughout their entire contractual relationship.

On the other hand, the relational proxy of "dynamism" clearly corresponds to the dynamic nature of the obligations established in investment treaties, and contributes to the economization of the transaction cost of bounded rationality of the parties by facilitating the cooperative adaptation of the contract, as their relationship evolves and unforeseen contingencies materialize. Dynamism is thus a natural result of the inherent incompleteness both of the default treaty standards and the underlying contractual provisions, which act as the gap-fillers in the interpretation of investment treaties.

The relational proxies of "mutuality" and "dynamism" will remain relevant for the interpretation of treaty standards, especially FET, even under the (unlikely) scenario that parties draft highly complete investment treaties. Besides, the parties drafting the so-called "second generation" treaties have acknowledged themselves the value of relationality by incorporating "relationship-building" language into their treaties using

longer preambles setting out the intricate policy "context" for international investment protection and its regulation.[586]

Summarizing the axes of the application of relational contract theory to the interpretation of investment treaties, the relational-contract elements forming part of the interpretative governance design proposed herein are the following: first, investment treaties create dynamic obligations established by inherently incomplete and vague standards. Second, such dynamic obligations can only be defined by the examination of the overall "relationship" of the parties (instead of a textualist approach focusing only on the "four corners" of the treaty).

Third, being inherently incomplete and vague, the treaty provisions are "default" standards that can be interpreted using the underlying contractual provisions as "gap-fillers" defining the standards' specific content on the basis of the particular "relationship" in dispute. Indeed, as *Arato* observes, investment treaties should not be used to rewrite contractual arrangements. On the contrary, investment-treaty norms apply to contracts as no more than defaults that the parties are free to contract around.[587]

Last, in the context of investor-state disputes arising from the renegotiation of concession contracts, this "gap-filling relationship" refers to the concession contract (itself relational, as analyzed above) between the investor and the host state. It is only such a broader definition of the "relationship" encompassing the interaction not only between states, as traditional treaty parties, but also between the state and the investor, as an unconventional yet increasingly important private actor under international law, that can capture the truly "hybrid", public-private of international investment law and arbitration, in particular.

In a similar way that contract theory in general has already been used for interpreting international treaties,[588] relational contract theory in particular is also not an unfamiliar territory for treaty interpretation. Both domestic and international courts have deployed relational-contract principles in this regard. In particular, American jurisprudence has adopted a norm according to which American courts interpret treaties both "liberally and in good faith so as to preserve amity among nations."

Similarly, the International Court of Justice has consistently held that subsequent state practice maintains probative value as to the meaning and understanding of treaty provisions. International courts have even ruled that "subsequent practice" can modify a

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[586] See *supra* Spears, S. (2010), The Quest for Policy Space in a New Generation of International Investment Agreements.
[587] See *supra* Arato, J. (2016), at 391-392.
[588] See the section "treaties as contracts" *supra* p. 178 et seq.

treaty counter to the "four corners" of the agreement.[589] Moreover, investment arbitrators have also already engaged in dynamic interpretation, for example in order to bring the UNCITRAL Rules on Transparency to effect in a particular case.[590]

This section showed the evolution in interpretative methods, starting with the static and one-sided investor's approach and moving towards approaches aiming to strike a balance between public and private interests, such as the comparative public law methodology. Nevertheless, it is the contractual approach that can reform the system from within, as it reflects the actually intent of the contracting parties, meant in a broad way as to include also foreign investors, as private actors, thus capturing the "hybrid", public-private nature of international investment law and arbitration. The aim in this context is the development of a "relational common law".

The following section examines the extent of the application of relational-contract principles, and especially the proxies of mutuality and dynamism, in interpreting FET in disputes involving a claim of treaty breach as a result of the renegotiation of concession contracts. The examination of the case law complements previous parts referring to the application of these relational proxies to "legitimate expectations" and the UNIDROIT Principles on hardship. The analysis concludes with the construction of a matrix (in Annex) categorizing the relevant arbitral awards along *Macneil's* spectrum of classical, neoclassical, and relational contracts.

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[589] See Wessel, J., *supra* note 164.

[590] Euler, D., Gehring, M. & Scherer, M. (2015) *Transparency in International Investment Arbitration, A Guide to the UNCITRAL Rules on Transparency in Treaty-Based Investor-State Arbitration,* Cambridge University Press, at 52.

1. The Argentine cases

The previous sections laid the doctrinal foundations for the application of relational contract theory to the interpretation of international investment treaties, and in particular their most invoked and contentious standard of fair and equitable treatment. This part examines the case law that arbitral tribunals have produced in treaty disputes that arose from the renegotiation of concession contracts and the ensuing claims for breach of the fair and equitable standard. The purpose is to identify potential interpretative patterns in those awards and explore whether arbitrators have used (even without stating so explicitly) the tenets of relational contract theory in interpreting FET, namely the proxies of "mutuality" and "dynamism".

The focus herein is on the cases that brought into light the mechanism of treaty arbitration as a prominent means of resolving disputes arising from the renegotiation of investment contracts. These were the disputes that resulted from Argentina's economic depression in 2001. The severe socio-economic crisis that Argentina suffered led the government to take a series of emergency measures that impacted the profitability of foreign direct investment in the country. As a result, more than forty claims based on treaties that Argentina had signed with investment-exporting countries were filed against the crisis-stricken state and gave birth to a series of high-profile, widely commented cases.

Although the Argentine cases have been extensively covered as regards the effect of the governmental legislative and regulatory measures on investment contracts, one of the core issues of the disputes remains highly under-analyzed. This is the legal evaluation of renegotiation "as process", and the "legal standard" applicable to determine the criteria distinguishing a legal renegotiation from one breaching the treaty, namely the FET standard.

Whereas this issue has been touched upon by arbitral tribunals, it has never been adequately addressed in their legal reasoning. For example, the *Suez* tribunal explicitly asked this question: "by what criteria, standard, or test is an arbitral tribunal to determine

whether the specific treatment accorded to the investments of a particular foreign investor in a given context is or is not "fair and equitable" ? [591]

Nevertheless, instead of addressing the legal question on the relationship between the contractual renegotiation and the breach of the treaty, the tribunals – making a logical lapse –moved directly to examining the "defenses" that the host state invoked (using inconsistent analyses and producing uneven results in this regard). Thus, the "renegotiation process itself" (including contractual renegotiations that took place before the last one that gave rise to the treaty dispute) has been mostly reduced to a mere factual matter, instead of a matter producing legal consequences that determine whether there was a "breach" of FET "in the first place".

The present thesis fills the gaps in the analysis of these arbitral awards, by opposing the characterization of the renegotiation process as a merely factual matter and arguing instead that the contractual renegotiations giving rise to a treaty claim are a prominently "legal issue with its proper applicable law and distinct legal consequences". As aforementioned, *Crawford* has pointed to the incorrectness of treating the law of the host state (including the renegotiation process taking place under its auspices) as a mere matter of fact.[592]

On the contrary, the Judge has argued that the standard applicable-law clause in BITs (as well as Article 42 of the ICSID Convention) mandates the application of the domestic law of the respondent state alongside international law. He has also highlighted that, even under the presumption that international law prevails over national law in case of inconsistency, this rule is an international rule of conflict of "laws", and, as such, does certainly not diminish national law to a mere matter of "fact".[593]

Within this framework, and by differentiating itself from the wide literature focusing on the affirmative "defenses" precluding the liability of the state based on a finding on breach of the treaty, the current study demonstrates that contractual renegotiations, under specified conditions, "preclude the breach itself" of an investment treaty. Those conditions are to be determined through an interpretation of the treaty - namely the FET standard - using "relational contract theory", and in particular the interpretative "proxies" of "mutuality" and "dynamism".

[591] See para 221 of the Suez award.
[592] See Crawford, J., *supra* note 59.
[593] See para 353 of the Suez award.

- *EDF International S.A., Saur International S.A. and Leon Participaciones Argentinas S.A. v. Argentina*

Apart from the legal significance of the crisis and the ensuing disputes as a sort of "natural experiment" for examining the relationship between treaties and the underlying contracts, the relevant cases remain - decades after their occurrence - as timely as ever. This is demonstrated, *inter alia*, by the recent claim that *EDFI*, a former shareholder of *EDF*, filed with ICC under a shareholders' agreement stipulating that the parent company of the current concessionaire (owned now by a local investor) is no longer entitled to cause the withdrawal or suspension of the EDFI-Argentina Claim under the ICSID Agreement.[594] Similarly, the case serves as an example of the importance of corporate governance structures (including shareholders agreements) at the level of adjudicating a treaty dispute.

The *EDF* case is an example of the rejection of the relational proxy of "mutuality", as the tribunal detached the conduct of the investor from the evaluation of FET.[595] In particular, it did not examine a series of (both domestic and international) corporate governance strategies in violation of the concession contract (and Argentine law), through which the claimants had built a pyramidal ownership giving them control of the consortium company.[596] Despite the fact that such illegal corporate practices affected significantly the operation of the public service provided by the concessionaire, their visibility "under international law", and particularly before international investment tribunals, has been almost inexistent.[597]

The tribunal also rejected the proxy of dynamism refusing to engage in an evaluation of the overall relationship, as it had evolved already from the "pre-crisis" phase. Nevertheless, a series of "pre-emergency" measures attest to the relational character of the concession contract. In particular, the government and the concessionaire had signed

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[594] https://www.iareporter.com/articles/icsid-claimant-goes-to-icc-arbitration-in-effort-to-prevent-discontinuation-of-bit-case-but-is-ultimately-unsuccessful/

[595] *EDF International S.A., Saur International S.A. and Leon Participaciones Argentinas S.A. v. Argentine Republic,* ICSID Case No. ARB/03/23, Award, 11 June 2012.

[596] Article 12 of the contract provided that the Investment Company owning the Majority Stake may not modify its holdings nor sell its shares during the first five years of entry into force without the previous authorization of the Executive Power. Similarly, the shareholders of the said Investment Company shall not be able to modify their holdings or sell their shares in the Company during the same period without the prior approval of the government of Mendoza. In violation of those rules, Crédit Lyonnais, a member of the consortium holding 70% interest in an Argentine company, MEDINVERT, which in turn held 40% of SODEMSA shares, incorporated Claimant León under Luxembourgish law as a wholly-owned subsidiary to hold Crédit Lyonnais' interest in MEDINVERT, and transferred to León its shares.

[597] Moreover, this type of forum shopping allowed the wholly-owned subsidiary of the French company to invoke the more favorable provisions of the Argentina-Luxembourg BIT, which (in contrast to the Argentina-France BIT) contained an umbrella clause.

a contractual-renegotiation agreement stipulating a procedure to honor the outstanding payments due to the Concessionaire.[598] The signing and execution of a renegotiation agreement to solve amicably the problems that arose during the implementation of the concession demonstrates the relevance of cooperative mechanisms to adapt complex, long-term contracts and preserve the parties' "relationship", as well as the importance of "process" for a cooperative, good-faith renegotiation.

Another relational element in the implementation of the concession contract was the engagement during the renegotiation process of different stakeholders, as a means to mitigate the problem of third-party opportunism, described above. The result of these stakeholders' consultations was a report proposing the acknowledgement of several million dollars to the concessionaire, according to which the average tariff would cover the operating costs of the concessionaire "but not the payment of principal or interest on its debt" thus refusing to compensate for the concessionaire's "highly leveraged" investments.[599]

Despite the relevance of the concessionaire's business decisions for its relationship with the state and the outcome of the renegotiations, this factor was not taken into account when the tribunal decided the claims on breach of FET. Indeed, the tribunal did not consider any of the above relational elements (and pieces of evidence, such as the stakeholders' report) in determining whether the disputed renegotiation violated the FET standard. On the contrary, it engaged in a strictly textualist interpretation of the treaty based on the Vienna Convention, while rejecting any evaluation of the investor's conduct as irrelevant for the purposes of adjudicating the alleged treaty breaches, and limiting its potential relevance only to the judgment of contractual claims under domestic law.

Among the elements that the tribunal should have considered in evaluating the investor's conduct when deciding the FET claim is the "overbidding" of the investor for securing the concession.[600] As analyzed above, overbidding is one of the main indications of strategic behavior, and specifically opportunism. Refusing to take into account this transaction cost while resolving a treaty dispute only contributes to fostering opportunism and moral hazard. Similarly, the tribunal's refusal to evaluate the alleged failure of the investor to comply with its due-diligence obligations during the implementation of the contract creates "uneven incentives" for the parties to comply with their contractual obligations. As a result, the parties are less incentivized during the implementation - including the renegotiation - of their contract to "cooperate in good faith", in order to

[598] See *supra* EDF v. Argentina, para 126.
[599] See EDF award, para 306. On the high level of leverage in project finance, see Engel, E., Fischer, R. & Galetovic, A. (2014), Finance and Public-Private Partnerships, Retrieved from: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.639.8549&rep=rep1&type=pdf
[600] See EDF award, para 306.

avoid being penalized for their non-cooperative behavior during a subsequent treaty dispute.

Another instance of the “investors’ rights approach” – which seems to be the methodology that the *EDF* tribunal opted for – is the use of the textualist interpretative method even when the wording of the treaty itself allowed for a more creative – or simply, balanced – interpretation. When applying the treaty’s provision inviting consideration of a wider range of “principles of international law” related to *fairness* and *equity*, the tribunal limited the meaning of this provision to a rigid and static textualist approach, according to which such principles “include the duty to aim for respect of specific commitments, such as the calculation of tariffs in dollars.” [601] On the contrary, it did not engage in any inquiry on “principles of international law” actually relating to fairness and equity, in particularly those promoting good-faith cooperation and adaptation of the parties’ relationship to changed circumstances.

With regard to the umbrella clause (considered as incorporated in the Argentina-France BIT by means of the MFN clause), the arbitrators decided that the serious repudiation of concession obligations is clearly a violation of commitments undertaken towards foreign investors, and that the dispute clearly implicated governmental acts. Moreover, they found that the use of “individualized” contracts, as opposed to regulatory frameworks based on general legislation, granted investors an additional protection against governmental opportunistic behavior, compared with general regulatory frameworks, which can be altered by new legislation. In this way, the tribunal recognized the central importance of the specific “contractual relationship” of the parties for the implementation of the concession. However, despite making explicit reference to the risk of governmental opportunism, the tribunal failed to account for the same risk from the side of the contractual counterparty, the foreign investor.

In an effort to ease the rigidity of the “investor’s-right approach” the tribunal clarified that the contours of the FET standard depend on the factual context of the host state’s conduct, particularly the socio-economic conditions on the ground. As a result, Argentina’s economic crisis was deemed relevant for interpreting FET, and the investor’s expectations had to be “balanced” against the host state’s need to protect the public interest. Nevertheless, it did not explain how such a balancing exercise would be implemented. Moreover, the reference only to the conduct of the state and not also of the investor, and especially the link between the investor’s conduct and its “expectations”, still goes against the relational proxy of mutuality.

[601] See paras 993, 1009, 1001 of the award.

Adopting elements of the "common-law" approach, the tribunal referred to the renegotiation process itself, holding that the breach of the Currency Clause was intrinsically linked to the failure of the "renegotiation process" to produce a new equilibrium between the interests of the renegotiating parties due to the repeated delays of local authorities, which continued to extend the deadline while maintaining the tariff freeze. Had the renegotiation process succeeded in striking "timeously" a new equilibrium between the parties, any liability from the alleged breach of the Currency Clause would have been a mere theoretical matter.

Similarly, the tribunal found that the renegotiation process was presumably conducted "in such a way" that Claimants were left with little alternative but to mitigate their losses by selling their investment to a local buyer.[602] By making reference to the "temporal" element of the investor's expectations, the tribunals implicitly endorsed the (proposed herein) relational proxy of "dynamism" while evaluating the investor's legitimate expectations and the ensuing breach (or non-breach) of FET.

Although the tribunal maintained that renegotiation was not conducted "in such a way" as to be a genuine attempt for rebalancing the contract, it did not clarify the alleged causal relationship between the renegotiation process *per se* and the breach of FET. On the contrary, it limited itself to a mere description of the timeline of renegotiations, without any elaboration on the details and the specific concessions that the negotiating parties had agreed to give to each other, for example the deferral of investment commitments.

In conclusion, the tribunal decided affirmatively on the breach of the FET standard as a result of the renegotiation of the concession contract. Nonetheless, despite the important legal consequences that the renegotiation process *per se* has for adjudicating the alleged breach of a treaty standard, the tribunal failed to elaborate on the criteria differentiating a renegotiation that breaches a treaty standard from one that is treaty-compliant. In a nutshell, the tribunal's evaluation of the renegotiation process was rather one-sided, focusing only on the conduct of the host state without any "holistic" examination of its causes (including the potential contribution of the investor to rendering renegotiation indispensable) and the particular reasons why the process amounted to a breach of FET.

This uneven evaluation of the renegotiation process and the FET standard is a result of the application of the rigid, textualist interpretative approach focusing only on the "four corners" of the treaty without allowing for the connection of the treaty standards with the underlying contracts and the behavior of both parties during their implementation. On the contrary, a connection between the treaty and the contract based on relational contract theory would enable arbitrators to have a holistic view of the reasons and outcomes of the

[602] See paras 989-990 of the award.

disputed renegotiation, thus incentivizing both parties to economize on the transaction cost of opportunism and limiting the risk of using investment arbitration as an "insurance mechanism" encouraging moral hazard.

- *Enron Corporation Ponderosa L.P. v. Argentina*

Another case where the tribunal took a similarly rigid, textualist approach ignoring the legal (and not merely factual) importance of renegotiation - both as a component of the parties' overall contractual relationship and as process - was the *Enron* dispute.[603] The parties in this dispute had conflicting perspectives on the relevance of the renegotiation process *per se* for evaluating the alleged breach of the FET standard.

On the one hand, Argentina argued that the renegotiation process was gradually advancing and that a good deal of contracts had been successfully renegotiated, whereas international claims had been an impediment to the expedient progress of the process. On the other hand, the claimant contended that the renegotiation process was politically motivated and not conducive to any solution for the concessionaire. *Enron* also rejoined that the regulatory framework was not incomplete, and the regulatory powers that a state has even in times of crisis are limited and subject to specific conditions, namely the maintenance of the economic balance of the contract.

The tribunal took a step further away from the "investors' rights approach" and closer to the proxies of mutuality and dynamism compared to the *EDF* tribunal, by recognizing the "necessity" of the contract's "renegotiation", but subjecting it to the condition that it is conducted "in an orderly manner". It thus held that the economic reality and the crisis that struck Argentina could not be ignored, and it is perfectly possible that economic conditions can change, as they dramatically did, with the ensuing profound effects on the economic balance of contracts and licenses. The tribunal also agreed with the Respondent's argument for a "fair and reasonable tariff". Hence, the issue was not anymore about keeping the contracts frozen but about allowing for their adaptation, including their negotiated modification, to the changed circumstances in an orderly manner, as provided for under the regulatory framework and the contract itself.[604]

Referring to the modification provisions of the contract and its regulatory framework the tribunal thus adopted a "neoclassical-contract-law" approach holding that the adjustment mechanisms (meaning the ordinary and extraordinary tariff reviews) incorporated in the concession agreement itself sufficed to achieve the necessary adaptation of the contractual relationship. However, this argument fails to explain the wide occurrence of

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[603] *Enron Corporation Ponderosa L.P. v. the Argentine Republic*, ICSID Case No. ARB/01/3, Award, 22 May 2007.
[604] Id., para 143.

actual renegotiations, i.e. material modifications of the concession agreement "outside the context of any contingencies and mechanisms stipulated in the contract itself". The perverse phenomenon of unplanned renegotiations points to the fact that, for different reasons (whether these are opportunism and over/under bidding or a radical change of circumstances) the adjustment mechanisms included in the contract are often not sufficient to achieve the necessary adaptation of the contractual relationship.

Moreover, although the tribunal moved closer (compared to the *EDF* tribunal) to recognizing the legal importance of renegotiation for achieving a new balance of the parties' contractual rights under the changed circumstances, thus precluding a breach of FET, it effectively showed disregard for the legal relevance of the renegotiation process itself. More specifically, it held that "whatever the virtues or shortfalls of the renegotiation process, the Tribunal is not called to pass judgment on any of its aspects as this depends exclusively on whether the parties agree or not on new contractual terms of the license". The tribunal added that "any process of renegotiation requires of course that the parties genuinely agree on the outcome and this cannot be imposed or forced upon one party." [605]

This thesis agrees that renegotiation shall be conducted in an orderly manner, but takes issue with the tribunal on its view that the renegotiation process itself, (including the manner in which it is conducted and its outcome) is irrelevant for evaluating whether there was a treaty breach. Quite the reverse, the renegotiation process is a core legal matter for determining whether a contractual renegotiation violated the FET standard, meaning that an orderly renegotiation *jure gestionis* shall not be considered as an act violating the treaty, as opposed to a renegotiation based on the unilateral exercise of sovereign power by the host state.

Recognizing the inherent incompleteness and vagueness of treaty standards calling for their dynamic interpretation, the tribunal agreed with the Respondent that the FET standard was none too clear and precise, and has evolved through a case by case determination that has produced a gradual and fragmentary formulation of "general principles of law" able to guide and discipline the evaluation of state conduct under investment treaty standards. Despite recognizing the importance of "general principles of law" for the dynamic interpretation of the treaty, thus echoing the "common-law" approach, the tribunal failed to apply the proxy of "dynamism" to the evaluation of the renegotiation process. Instead, endorsing the "investors' rights approach", it held that "legal stability" is an emerging standard of fair and equitable treatment in international law, according to the interpretation of the treaty based on Article 31 of the Vienna

[605] Id., para 186.

Convention,[606] but without explaining what makes "legal stability" such an emerging standard and component of FET.

Whereas the argument for the "gradual evolution of general principles of international investment law" applicable to the interpretation of FET is valid, a more balanced view is needed to identify those general principles contributing to achieving a balance between the interests of the investor with those of the host state. As analyzed above, the UNIDROIT Principles of International Commercial Contracts, and especially their provisions on hardship, can be considered as emerging principles of international investment law, able to strike such a balanced equilibrium in the relationship of the renegotiating parties.

Despite generally adopting a combination of textualism and the investors' rights approach, the tribunal also observed that the "stabilization requirement" - particularly the protection of the investor's "legitimate expectations" as formed at the time of the investment - does not mean the freezing of the legal system or the regulatory power of the state, especially in the face of radically changed circumstances. However, despite recognizing the legal significance of those changed circumstances, the arbitrators did not explain how the two conflicting principles, the stability vs. the adaptability of concession contracts, shall be balanced against each other in order to produce a new contractual equilibrium fair to both parties.[607]

Moreover, the tribunal strayed towards the "common-law approach", and especially its emphasis on process, in judging that the frustration of the investor's legitimate expectations resulted from the way that the renegotiation process *per se* was conducted. It emphasized in this regard the dismantling of the guarantees of the tariff regime a decade after their establishment, and the ensuing doubt and ambiguity that took the place of certainty and stability. Also, the tribunal maintained that the initial long-term business outlook was transformed into a day-to-day discussion about what comes next, and the re-establishment of the tariff regime was subjected to a protracted renegotiation process, which was imposed on the public utilities and failed to provide a final and definitive framework for the business operations in the energy sector.

The recognition of the necessity and legality of renegotiation in the face of hardship is a step towards the relational proxy of dynamism dictating the cooperative adaptation of the contract under such circumstances. The criterion, therefore, differentiating a legal from

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[606] Id., paras 256-260.

[607] On the other hand, contract theory takes a less one-sided view (than the textualist and investors' rights approaches) by recognizing the tension between stability and flexibility in international investment law, and the need for proper legal tools for balancing these two conflicting principles. See van Aaken, A., *supra* note 520.

an illegal renegotiation under the treaty is the process itself. In other words, had the (indispensable) renegotiation process been conducted in an orderly and depoliticized manner, the enquiry on the breach of the FET would and should have led to different results. In this regard, this thesis is certainly sympathetic to the claimant's argument about the politicization of the process. An orderly renegotiation precluding a breach of FET must necessarily be a depoliticized renegotiation driven by due process.

- *LG&E v. Argentina*

The tribunal in the *LG&E* case[608] recognized the relational proxy of dynamism in its interpretation of FET and observed that the Treaty does not define the standard. Based on the requirement for an interpretation "in good faith" according to Article 31(1) of the Vienna Convention on the Law of Treaties, the tribunal highlighted that the "generic" nature of the standard makes it difficult to establish an unequivocal and "static" interpretation of its content.[609] By rejecting such a static interpretation the tribunal alluded to the limits of the textualist methodology of the Vienna Convention for imparting meaning to open-ended standards.

Despite endorsing "dynamism" in interpreting FET, the tribunal rejected "mutuality" siding instead with the investors' rights approach. Drawing from the provisions of the Preamble, according to which "fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources", and from relevant case law, the tribunal held that "the stability of the legal and business framework" in the host state is an essential element of fair and equitable treatment and an "emerging interpretation" of the FET standard.[610]

Moreover, departing from its own observation that FET cannot be subject to a static interpretation, the tribunal endorsed a static and one-sided interpretation of "legitimate expectations", as part of FET, holding that, in addition to legal and business "stability", the investor's "legitimate expectations" "at the moment it made its investment", are also considered a central element of FET. In particular, the tribunal ruled that "legitimate expectations" are based on the conditions offered by the host state "at the time of the investment"; they may not be established "unilaterally" by one of the parties; nevertheless, the investor's fair expectations cannot fail to consider parameters such as business risk or industry's regular patterns.[611] The recognition of "non-unilateralism" as a

[608] *LG&E v. Argentina*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006.
[609] Id., para 123.
[610] Id., para 125. See also *CMS*, para 274; *Occidental*, para 183; and *Metalclad*, para 99.
[611] Id., para 130.

component of “legitimate expectations” is a step towards the endorsement of the relational proxy of mutuality.[612]

Last, regarding the renegotiation process itself, the *LG&E* tribunal followed an approach similarly minimalistic to the one of the aforementioned tribunals, devoting just one paragraph on the matter, and holding that Argentina acted unfairly and inequitably by forcing the licensees to renegotiate and waive the right to pursue claims against the government or risk rescission of their contracts. Without citing any evidence in this regard it concluded that, even though the Gas Law provided for the renegotiation of public service contracts, in practice there was no real renegotiation but the process was rather imposed upon the foreign investor.

- *CMS v. Argentina*

Textualist and static (thus akin to classical contract law) was also the approach of the *CMS* tribunal, which held that the purpose of the License was to guarantee the stability of the tariff structure, especially the calculation of tariffs in dollars and their indexation to the US PPI. Although devaluation could happen at some point - the tribunal continued - the tariff structure was supposed to remain “intact” within the “initial” framework of “stability” envisaged, as it would adjust automatically to the new level of the exchange rate.

Nevertheless, the tribunal strayed towards the neoclassical-contract-law approach by examining the adjustment mechanisms incorporated in the contract. It held in this regard that it did not have to look at general principles of law to find an answer on how the contract could be adjusted to the new economic realities, but sufficed to examine the pertinent mechanisms embodied in the law and the License itself. The tribunal concluded that a rebalancing of the economic equilibrium of the contract was required in the face of the changed circumstances, but the necessary adjustments could be accommodated within the structure of the guarantees offered to the Claimant and not through a unilateral amendment of the License.

However, the same tribunal took a different, more flexible and dynamic view later in its analysis, when addressing the respondent’s argument of *imprevision*, referring in this regard to the decision in the *Gaz de Bordeaux* case. Leaning towards a relational-contract-theory interpretation, it found that there are circumstances in which “the

[612] For a more elaborate analysis of the concept of “legitimate expectations” as a factor connecting the relational contract with the treaty, see *supra* chapter II. See also Sauvant, K. & Ünüvar, G. (2016), *supra* note 454.

adjustment mechanisms incorporated in the contract may be insufficient", and therefore a "renegotiation" of the contract is needed. It cited in this regard the reasoning of the *Conseil d'Etat* holding that the economic impact of the war "led to such price increases that the adjustment envisaged under the contract was clearly insufficient", and the economic viability of the contract was profoundly affected.[613]

As a result, the Court judged that during the emergency period the concessionaire shall only bear that part of the adverse consequences that "the reasonable interpretation" of the contract allows.[614] The reference to a standard of "reasonable interpretation" brings the Court's reasoning closer to relational contract theory, which supports the use of extra-contractual adjustment mechanisms, as opposed to the more rigid neoclassical approach limiting itself to the adjustment mechanisms incorporated in the contract. The *Conseil d'Etat* concluded that the state would have to cover part of the expenses of the hardship-hit investor, and that "failing the agreement of the parties on the amount to be paid, this would have to be fixed by Court decision." [615]

Much like the *Gaz de Bordeaux* case, where the state accommodated the investor's request to adapt the contract to the hardship occurred due to an unforeseen event, the relational proxy of mutuality requires from the concessionaire to equally respond to the state's request for adaptation of their contract (even more so given the severe negative externalities that the rigid observance of the contract would produce for the consumers). Moreover, the fact that the court could intervene to adapt the contract, in case of failure of the parties' renegotiation process, shows that there is a need for wider "remedies" in investment arbitration than a mere recourse to damages (which risk substituting arbitration for insurance, thus increasing moral hazard).

Leaving aside the finding on the non-fulfillment of the conditions of *imprevision* in the present case, this thesis sides with the tribunal's examination of the doctrine already at the stage of determining whether the contractual renegotiation constituted a breach of the treaty in the first place, and not at the stage of the examination of the respondent state's defenses. Although the tribunal deemed the crisis to be a mere factual matter without legal implications, it examined the legal consequences of renegotiation already at the stage of interpreting and applying the FET standard, and not as a defense, after a breach of FET had been established. This is in line with the relational-contract-theory argument for the mutual interrelation between the contract and the treaty, meaning that not only does the treaty lead to the internationalization of the underlying contracts, but also these contracts, as renegotiated, impact the interpretation of the overarching treaty standards.

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[613] Conseil d'Etat, Compagnie Générale d'Eclairage de Bordeaux, Rec. 125, concl. Chardenet, 30 Mars 1916, in M. Long, P. Weil et al. Les Grands Arrêts de la Jurisprudence Administrative, 2003.
[614] Id. paras 228, 238-242 of the *LG&E* award.
[615] Id., para 243.

Nevertheless, the tribunal concluded that Argentina had breached the FET standard. Despite siding with the respondent in that the standard was not defined in the treaty and was somewhat vague, it did not look into wider sources (including the contract) to identify its meaning. On the contrary, relying on the Preamble's recital on the desirability of a stable framework for investments and maximum effective use of economic resources, the tribunal equaled fair and equitable treatment with the stability and predictability of the host state's investment framework. It even went as far in adopting such a static, "investors' rights approach" as to consider such stability and predictability, *founded on solemn legal and contractual commitments*, part of the minimum standard of protection under customary international law, without explaining, though, how it arrived at such a conclusion.

In a similar vein, the tribunal did not expand on the nature of the strong interrelation between the "solemn legal and contractual commitments" and the content and effects of the treaty standard either. If a breach of contractual commitments entails a breach of the FET, how the perverse phenomenon of contractual renegotiations, as regular practice of the parties, is to be justified? How "solemn" are contractual commitments that change frequently throughout the life of the contract, as in fact has happened with the universe of concession contracts? In the changing environment of complex, long-term, and idiosyncratic contracts, the only solemn promise and "legitimate expectation" is the collaborative, good faith renegotiation of the contractual terms, when such need arises.

Another related inconsistency in the tribunal's reasoning is the mismatch between the law applicable to the merits of the dispute and the facts in question. On the one hand, in its findings on the applicable law, the tribunal emphasized the close interaction between the legislation and the contract.[616] This finding is not consistent with its decision that "renegotiation, adaptation and postponement of the contractual relationship had occurred but the essence of the international obligations remained intact." [617] On the contrary, in cases of highly intertwined instruments, as a regulatory contract and a treaty standard are, the law applicable to the dispute ensues from the interaction of the two instruments. This interaction is a dynamic relationship, in a similar way that the contested regulatory contract itself is also dynamic and subject to renegotiation. In other words, the change of the essence of the regulatory contract affects the essence and content of the related treaty standard.

Last, as regards the evaluation of the renegotiation process itself, following the path of previous tribunals, the *CMS* tribunal did not elaborate on the alleged causal relationship between the renegotiation process and the breach of FET, but limited itself, instead, to a mere description of the timeline of renegotiations, without elaborating on the details and

[616] See para 117 of the CMS award.
[617] See para 161 of the award.

specific concessions that the parties had agreed to give to each other, (for example the deferral of investment commitments). Moreover, rejecting the proxy of mutuality, the tribunal judged the investor's legitimate expectations only against the conduct of the host state without taking into account also the conduct of the investor itself, by addressing *inter alia* the questions of overbidding, excessive leverage, and poor performance.[618]

- *Sempra Energy International v. Argentina*

As in the *Enron* case, the arbitrators in *Sempra* refused to pass judgment on the features of the renegotiation between the Licensees and the host state, let alone between the shareholders in the concessionaire company.[619] It also noted that the Claimant had not accepted the agreement between the concessionaire and the government, and the tribunal thus had to decide whether the Claimant was bound by such agreement. Despite concluding that corporate arrangements fall under the jurisdiction of the national courts, the tribunal delved into corporate law[620] holding that the Claimant cannot be bound by the renegotiation agreement between the licensee and the host state, as it had not consented to it.[621]

Conflating the relationship between domestic law and international law in evaluating the legal effects of the renegotiation under the treaty, the tribunal did not explain why shareholder claims for reflective loss are covered by the treaty, and more specifically why the renegotiation agreed between the concessionaire and the host state constitutes a breach of the shareholders' rights under the treaty.

In the same way that such renegotiation is "res inter alios acta" regarding the relationship between the claimant shareholder and the host state,[622] the shareholder structure of the concessionaire is also "res inter alios acta" for the host state that signed (and renegotiated) the contract with the concessionaire itself. If, on the contrary, the concessionaire's shareholder structure is considered relevant for the admissibility of a treaty claim, then, based on the proxy of mutuality, the violation of an agreement on this

[618] See paras 197-198 of the award.
[619] *Sempra Energy International vs. Argentine Republic,* ICSID Case No. ARB/02/16, 28 September 2007.

[620] On "investment treaties as corporate law", see Gaukrodger, D. (2013), Investment Treaties as Corporate Law: Shareholder Claims and Issues of Consistency. A preliminary framework for policy analysis, Retrieved from: http://www.oecd.org/corporate/WP-2013_3.pdf
[621] See *supra* note 618, para 227.
[622] See para 227 of the award.

structure between the investor and the host state shall preclude the investor from pursuing its rights under the treaty.[623]

Violating an agreement between the concessionaire company and the host state regarding the company's shareholder structure in order to illegally gain control over the concession, while denouncing a renegotiation that the state achieved with the concessionaire in order to pursue a treaty claim (based on such illegally-obtained shareholder rights) is an abuse of rights that should lead to the inadmissibility of the ensuing treaty claim.

Moving a step closer to the proxies of mutuality and dynamism than previous decisions, the tribunal distinguished between unilateral and consensual renegotiation as having different legal implications regarding their compatibility with the treaty. More specifically, applying Argentine law, it judged that the "rebalancing" of contracts was allowed under the theory of *imprévision*, and held that "imprévision has been recognized as a general principle of law".[624] The establishment of new rights between the parties is possible "as long as it is the product of renegotiation and not the mere intervention of regulatory authorities or the government".

The tribunal concluded that it was not the License corrections themselves (which were required in the light of the new circumstances) that were illegal "but the government's unilateral adjustment" of the contractual relationship. In other words, whereas the renegotiation itself was indispensable, it should be implemented in a way that would achieve a new, fair balance between the interests of the renegotiating parties.

What is more important in the context of treaty disputes resulting from contractual renegotiations, is the tribunal's finding that a lawful renegotiation can be decided in two ways: either as the result of an agreement between the parties, "or requested by a judge." [625] The argument for a judge-ordered renegotiation supports the proposal made below for the use of "conciliation or mediation" as the proper means of resolving disputes arising from contractual renegotiations, thus fostering adaptive governance as a central mechanism for the successful implementation of relational contracts.

Recognizing the inherent incompleteness of FET, the tribunal shared the Respondent's view that the standard was none too clear and precise. Moreover, taking an integrationist contract-treaty approach, it held that the FET standard was based on the principle of

[623] For example, see id, p. 3 on the violation of the concessionaire's agreed shareholder structure by one of the Claimants, Crédit Lyonnais. Another example of such unauthorized transfer of interests was the case of *Occidental v. Ecuador*.
[624] See paras 243-244 of the *Sempra* award.
[625] Id., paras 254, 256, 258.

"good faith" as a measure for protection "under both contracts and treaties",[626] and incorporated the concept of "legitimate expectations". The tribunal defined the content of FET as contingent on the facts of each dispute, and found that there was a substantial amendment of the legal and business framework under which the investment was made. Without clarifying the exact elements constituting a breach of FET, the tribunal also noted that the initial long-term business outlook had been transformed into a day-to-day discussion about what is next to come.

As regards specifically the claim on the frustration of the investor's legitimate expectations due to renegotiation, the tribunal (like the previous ones) refused to take into account the conduct of the investor while evaluating its legitimate expectations, thus rejecting the relational proxy of mutuality. Despite the "Respondent's arguments that its own expectations were equally frustrated" in several respects, including the frustration of good-faith working standards by the investor and the observation of contractual commitments, the tribunal pointed to the Respondent's option to raise a counterclaim in this regard, noting, though, that this right has been exercised only restrictively.[627]

The narrow remedy of counterclaims is not enough for the host state to invoke frustration of its own legitimate expectations. On the contrary, the conduct of the investor shall always be taken into account already at the phase of determining whether a breach of the FET standard took place.

- *Siemens A.G. v. Argentina*

The *Siemens* tribunal took a different perspective on the legal implications of renegotiation as process, following in particular the common-law approach and its emphasis on the importance of "law as process".[628] The claimant itself distinguished between two types of renegotiation, the one based on the Contract Restatement Proposal and the renegotiation that was imposed under the Emergency Law.

According to *Siemens'* contention, the government initially set up a Commission that agreed, upon negotiations with the Claimant, on new contractual terms. However, following the change in government, the new Minister of Interior refused to validate the agreement of his predecessor, proposed a new Draft Proposal, and terminated unilaterally

[626] On the integrationist approach to contract and treaty claims, see *supra* Chapter II, especially Crawford, J., *supra* note 59.
[627] Para 289 of the *Sempra* award.
[628] *Siemens A.G.v. the Argentine Republic*, ICSID Case ARB/02/8, Award, 17 January 2007.

the contract.[629] Argentina was thus accused of taking advantage of the sunk costs of Siemens' investment to impose a politically opportunistic renegotiation process not provided for in the contract.[630]

The tribunal accepted this differentiation and found only the renegotiation imposed by law to be incompatible with the treaty, as act *jure imperii*. Consequently, it decided that for the state to incur international responsibility, it must step out of its role as a contractual party and use its "superior governmental power". By applying this criterion to the case in dispute, the tribunal found that Argentina used its sovereign authority on several occasions, particularly by requiring changes in the economic equation of the contract "when the change of government occurred". In this way, "forced renegotiation" was considered as an act going beyond the contractual relationship of the parties and falling into the realm of acta *jure imperii*.[631]

By accepting the distinction between renegotiation as act *jure imperii* and renegotiation as act *jure gestionis*, and their different legal consequences, the tribunal (implicitly) acceded to the relational-contract-theory argument for the inadequacy of the adjustment mechanisms stipulated in the contract, and the ensuing necessity of its renegotiation. It also endorsed the common-law approach regarding the importance of "process" for determining the legality of a renegotiation, meaning that an orderly and consensual [632] renegotiation process would not constitute a breach of FET, as opposed to a unilaterally imposed and forced process.

However, following a line of reasoning similar to that of previous awards, the *Siemens* tribunal did not accept the respondent's arguments for an interpretation of FET based on "mutuality". In particular, it did not take into account Argentina's argument that the FET standard is based on good faith applying "equally" to investors and states, nor its claim that *Siemens* breached the standard during the failed negotiations, *inter alia* by "systematically withholding information" on its cost structure. The problem of information asymmetries exemplifies the interconnection between the transactions costs of opportunism and bounded rationality, as the strategically-behaving party can take advantage of the bounded rationality of its counterparty by withholding its superior and material information in order to opportunistically shift rents to its benefit.

Similarly, the tribunal did not evaluate Argentina's arguments about the investor's under- or non-performance of the contract, and the frustration of the host state's expectations

[629] See para 111 of the *Siemens* award.
[630] Id., para 141.
[631] See paras 253-260 of the award.
[632] Of course within the limits of the law that may make renegotiation mandatory under certain circumstances, as stipulated in the hardship provisions of the UNIDROIT Principles of International Commercial Contracts.

that *Siemens* had created through the statements that it made when bidding for the concession. On the contrary, it rejected the respondent's argument that the investor was *estopped* from bringing a claim regarding the renegotiation of the contract, given the fact that it had subjected itself to the process, and held instead that neither party may hold against each other positions that they may have taken during a good-faith renegotiation.[633] By refusing to evaluate the conduct of the investor, especially the Respondent's argument on *estoppel* and the frustration of its own legitimate expectations, including those created by implementing renegotiation as an "established practice" of the parties, the tribunal rejected the relational proxy mutuality in interpreting FET.

- *BG Group Plc. v. Argentina*

Another case that addressed the impact of the renegotiation between the host state and the concessionaire on the jurisdiction of the tribunal for shareholder claims against the host state, was the *BG* dispute.[634] Like in *Sempra*, the *BG* tribunal held that BG's treaty claims (as a controlling shareholder in the concessionaire company) are independent of the renegotiation process, and "it is not for the tribunal to rule on the perspectives of the renegotiation process or on what TGN might do in respect of its shareholders." [635]

Relying on the *LG&E* case, the tribunal considered "legitimate expectations" to be a core component of the FET standard. Following the same definition of the concept as *LG&E*, it adopted a "static" interpretation ruling that investor's expectations are based on the conditions offered by the host State "at the time of the investment" and they may not be established "unilaterally" by one of the parties.[636] The reference to non-unilateralism would allude to the proxy of mutuality, had the tribunals' interpretation not restricted the meaning of the concept only to the evaluation of the state's behavior and the distinction between renegotiation *jure imperii* and renegotiation *jure gestionis*.

The tribunal added that bad faith of the host state was not a prerequisite for breach of FET.[637] Despite the static interpretation of "legitimate expectations" it adopted an evolutionary approach to the "minimum standard of treatment" under customary international law holding that the standard has evolved since the *Neer* case. In an analysis, though, that seemed to conflate different legal standards, namely the international minimum standard and the investor's "legitimate expectations", as possible,

[633] See paras 132, 280, 306 of the *Siemens* award.
[634] *BG Group Plc. v. the Republic of Argentina*, UNCITRAL Arbitration Rules, 24 December 2007
[635] Id., para 239.
[636] Id, para 297. See also *LG&E*, *supra* note para 130. Emphasis added.
[637] Without applying the same criterion to the behavior of the investor during or before the renegotiation.

alternative components of FET, the tribunal decided that in any case Argentina's conduct fell behind the international minimum standard, because it breached the "specific commitments" that it had made to the investor, and by extension, the principles of stability and predictability deemed as inherent in the FET standard.[638]

- *Total S.A. v. Argentina*

Another case serving as a good example of the different types of renegotiation and the legal importance of renegotiation as process is the *Total* dispute.[639] On the one hand, the first renegotiation law defined the criteria under which such renegotiation would take place, and established a single Commission for the renegotiation of all concessions and licenses. The main renegotiation criterion was the "principle of shared sacrifice", and the objective of the process was the adaptation by mutual consent of the concession to the emergency situation, thus stressing the importance of adaptive governance in the context of complex, long-term contracts.

On the other hand, though, the rules of the renegotiation game changed in the course of the process, which seemed to become all the more politicized when the new (Kirchner) government established a new mechanism for carrying out the renegotiation process both outside of the Gas Regulatory Framework and independent of the Renegotiation Commission that the previous government had set up.

Departing from the more static and one-sided interpretation deployed in the aforementioned awards, the *Total* tribunal engaged with the relational proxies of mutuality and dynamism. First, it admitted the flexible and inherently incomplete nature of the FET standard, which makes it "difficult, if not impossible, to anticipate in abstract the range of possible types of infringements upon the investor's legal position." [640]

In a similar vein, it criticized the textualist method by pointing to the limits of the VCLT for interpreting FET. Endorsing a dynamic interpretation instead, the tribunal noted that "whereas several tribunals have based their analysis of FET on Article 31(1) of the Vienna Convention of the Law of Treaties in examining the "ordinary meaning" of the term, it has also been clear that the judgment on the content of the standard is an *ad hoc* one that must be adapted to the circumstances of the case." To this end, it endorsed the approach in *Vivendi II*, according to which the reference to principles of international law

[638] See para 307 of the *BG* award.
[639] *Total S.A. v. Argentine Republic*, ICSID Case No. ARB/04/1, Decision on Liability 27 December 2010.
[640] Id., paras 81, 84, 89, 107. See also Schreuer, C. (2005), Fair and Equitable Treatment in Arbitral Practice, Journal of World Investment and Trade, 6 (3): 357, at 357, 365.

supports a broader reading inviting consideration of a wider range of international legal principles (than just the minimum standard of treatment).[641]

The tribunal found "good faith" to be the overarching general principle of law which the FET requirement derives from, and to be applicable for interpreting the standard, according to Article 38(1) of the Statute of the International Court of Justice.[642] This approach stands in contrast with the interpretations in *BG*, where good faith was considered as irrelevant for interpreting FET, and *CMS*, which held that it did not have to look into general principles of law to interpret the standard.

Like previous decisions, the *Total* tribunal considered "legitimate expectations" to be a key element of the FET standard. Despite acknowledging the inherent incompleteness of the concept - pointing also to the lack of coherent case law in determining which expectations are "legitimate - it took a rather static approach to its interpretation by using as proxies the stability of the legal framework applicable when the investment was made.[643] Instead of looking at the tools of contract theory as an internal mechanism to interpret FET, the tribunal turned for assistance in balancing the conflicting objectives of legal stability and regulatory flexibility to external sources, namely the WTO rules on specific commitments in Services.

To this end, it drew guidance from the GATS' provisions on domestic regulation and simulated "legitimate expectations" under the treaty with "specific commitments" under the GATS rules. In particular, the tribunal held that the GATS requirements for administering measures in a reasonable, objective, and impartial manner provide useful guidance in the context of investment law regarding the requirements that a domestic regulation must contain in order to be considered "fair and equitable".[644]

Without explaining the reasons for choosing the GATS rules as the methodology for interpreting FET, the tribunal added to this interpretative ambiguity by ruling that, besides such an "objective" comparison of the competing interests, "the conduct of the investor in relation to any undertaking of stability is also, so to speak, "subjectively" relevant". Despite the ambiguity of this statement, the reference to the conduct of the investor attests to the tribunal's sympathy for the interpretative proxy of mutuality. The tribunal also cited previous awards that had evaluated such conduct, highlighting that

[641] Id., paras 109, 127.
[642] For a more elaborate analysis of the (potential of the) application of general principles of law in evaluating the alleged breach of FET ensuing from a contractual renegotiation, see *supra* Chapter II, section on the UNIDROIT principles of international commercial contracts.
[643] See para 119 of the *Total* award *supra* note See also *CMS*, Decision on Jurisdiction, para 27.
[644] See Article VI of the GATS 1994, and para 123 of the *Total* award.

BITs "are not insurance policies against bad business judgments", and the investor has its own duty to investigate the host state's applicable law.[645]

Despite its initial reference to the time when the investment was made, as the point determining the establishment of "legitimate expectations", the tribunal eventually took a more dynamic approach to interpreting "specific commitments", holding that these are contingent on the efficiency of the investor in managing the concession, and cannot be isolated from the (inevitably) mutable socio-economic environment in the host state.

In this context, the tribunal found it imperative to examine the conduct of the investor to determine whether the Claimant had any "legitimate expectations", and ruled that, from a business point of view, an experienced international investor such as *Total* could not have considered the tariff suspensions that had already been in place (and had given rise to the *CMS* dispute) as irrelevant for deciding to invest in the concession.

On the contrary, an objective risk analysis of the situation should have alerted the claimant to the fact that the stability of the gas regime was being undermined. Moreover, it found *Total's* reasoning to be contradictory with regard to its claim that it did not weigh these negative developments, because it was focusing rather on the long-term perspectives of its investment (which would have been in line with the nature of FET as a dynamic and relational obligation), however at the same time it based its claim on a static view of legitimate expectations, i.e. the frustration of the stability of the regime as it stood when it invested in the country.

Consequently, the award held the pesification of utility tariffs to be reasonable given the (dramatic) change of circumstances and the inherent flexibility of FET. The tribunal also found that "no expectations could reasonably be maintained (even less so, legitimately) according to which only utility tariffs would be exempted from such a measure, especially as *Total* was not a beneficiary of any specific promise (as it only invested in the concession later on).[646]

Recognizing the legal relevance of renegotiation as process, the tribunal was less sympathetic to the way the process was administered, including the maintenance of the tariff freezing after 2002. The reference to this temporal dimension of FET shows the

[645] See para 124 of the *Total* award. See also *Maffezini v. Spain*, ICSID Case No. ARB/97/7, Award, 13 November 2000, para 64, and *MTD v. Equity Sdn. Bhd. & MTD Chile S.A. v. Chile*, ICSID Case No. ARB/01/7, Award, 25 May 2004, para 178.

[646] See paras 156-164 of the *Total* award. A similar reasoning on the preclusion of the claimant from claiming any "legitimate expectations" can also apply to the corporate-governance structure of the concessionaire company, in order to preclude an investor to the latter to obstruct a renegotiation process and bring individual claims against the host state, in spite of never having contracted (and renegotiated) directly with it.

tribunal's endorsement of the proxy of dynamism. Reiterating the neoclassical-contract-law principles for the adjustment of the economic equilibrium as per the adjustment mechanisms prescribed in the contract - namely the ordinary and extraordinary reviews - the tribunal observed that the Emergency Law and the initial renegotiation process based on it, maintained those principles.

These principles were frustrated, though, by the new government that allegedly politicized renegotiation, dragging the process by establishing repeatedly new deadlines and causing protracted delays for almost six years, the gradual recovery of the Argentine economy since 2002, and eventually discontinuing any tariff adjustments. Consequently, the tribunal concluded that renegotiation, and particularly the failure to readjust tariffs, could have been justified when the Emergency Law was enacted and during the height of the crisis, provided that Argentina had subsequently pursued successful renegotiations to re-establish the equilibrium of the tariffs, as provided by the law. This, however, did not happen, due to the inconclusive results of the renegotiation process entrusted by the government to the regulator (UNIREN).[647]

This way the tribunal adopted a dynamic interpretation of FET, accepting that there are cases wherein the neoclassical-contract-law adjustment mechanisms incorporated in the contract do not suffice, and a renegotiation is instead indispensable. The tribunal's interpretation also bears elements of mutuality in that it took a cooperative approach to renegotiation, accepting its necessity under certain circumstances, but pointing also to the need for a good-faith adaptation of the economic equilibrium of the contract balancing the interests of both parties.

Pointing to the contractual re-balancing of the parties' interests based on mutuality and dynamism, the tribunal thus adopted the relational-contract methodology instead of resorting to external methodologies, such as the WTO weighing and balancing test, or proportionality analyses. On the other hand, what this thesis proposes is a balancing methodology internal to the system, and in particular based on the tools of contract theory – and specifically, relational contract theory. Being internal both to the parties' contractual relationship and the treaty (which in fact is a bigger contract involving to a certain extent the same parties), the balancing tools of relational contract theory provide solutions representing the actual intent of the parties better than external methodologies prone to the policy preferences of a particular ideological camp.

[647] Id., paras 174-175. On the problem of regulatory capture and other institutional failures, see *supra* Chapter I.

- *National Grid P.L.C. v. Argentina*

Different from *Total* was the reasoning in the *National Grid* dispute,[648] where the tribunal adopted a textualist approach to interpreting FET. After citing several synonyms in an attempt to determine the content of the standard according to its "ordinary meaning", based on Article 31 of the VCLT, it concluded that the content of the standard is too broad and imprecise, and very fact- and context-specific. The tribunal then turned to the Preamble of the treaty for assistance, and found that the purpose of the treaty is "the encouragement and reciprocal protection under international agreement of such investments that will be conducive to the stimulation of individual business initiative and will increase prosperity in both states." Thus, it observed that the obligation of fair and equitable treatment falls squarely within the scope of the obligation to "encourage and protect" foreign direct investment.

Such reading of the Preamble is one-sided as not looking at the overall purpose of the investment treaty, which also includes the promotion of the prosperity of the host state. A balance between the interests of the host state and the foreign investor requires a balanced interpretation of FET by examining the conduct of both parties, particularly by evaluating the conduct of the investor to identify whether it had any "legitimate expectations".

The tribunal also adopted a static approach in considering the investor's "reasonable expectations "at the moment it made its investment" to be incorporated in the FET standard. Despite this initially static approach, though, it subjected the protection of those legitimate expectations to two caveats: first, the investor should not be shielded from ordinary business risk of the investment and second, the investor's expectations must have been reasonable and legitimate in light of the circumstances. Moreover, the tribunal clarified that the determination whether FET was breached, "must be qualified in time", and the standard is not an absolute parameter. On the contrary, what would be unfair and inequitable under normal circumstances, could well be "fair and equitable" in the context of a crisis situation.

Consequently, the investor could not be insulated from the situation of a severe economic crisis and the ensuing measures that Argentina took in 2001. As a result, the tribunal concluded that the breach of the standard did not occur at the time the measures were taken in the midst of the crisis, in 2001, but it did occur from 2002 onwards as a result of a "failed renegotiation process" during which the state imposed *inter alia* the obligation on the investor to waive all its legal remedies linked to the concession contract.[649]

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[648] *National Grid P.L.C. v. Argentine Republic*, UNCITRAL, Award, 3 November 2008.
[649] Id., paras 171-180.

This thesis endorses the reasoning in *National Grid* regarding the proxy of dynamism, which the tribunal ultimately adopted in interpreting FET as a dynamic, evolving, and context-contingent standard. Moreover, it agrees with the tribunal's finding that the renegotiation process *per se* and the way it is conducted are relevant for determining whether a renegotiation was (un)fair and (in)equitable. However, it takes issue with the tribunal on the lack of mutuality in interpreting the standard, since the tribunal did not evaluate the conduct of the investor in this regard.

More specifically, the tribunal refused to take into account previous renegotiations of the contract, led by the investor. On the contrary, it considered the transparency of such investor-led renegotiations as irrelevant for evaluating the investor's conduct under the treaty. Instead, it limited itself to stating that no evidence had been presented that the Privatization Committee had prohibited the practice of verbal claims and renegotiations, but that, nevertheless, it is beyond doubt that written communications would have been to the benefit of all interested bidders.[650] Such one-sided approach only serves to incentivize investors to engage in rent-seeking renegotiations under the domestic law of the host state, since such conduct would remain unexamined and unpunished under international law, when a relevant treaty dispute arises.

- *Hochtief AG v. Argentina*

The phenomenon of renegotiation as "regular practice" of the parties forming an indispensable part of their contractual relationship even before a major change of circumstances due to an external shock occurs, was illustrated also by the *Hochtief* case, which similarly exemplified the acute corporate governance problems characterizing the operation of concession contracts. More specifically, the concessionaire in this case had difficulties in obtaining financing already prior to the crisis and the ensuing pesification of public contracts, as evidence showed that it had suspended the implementation of the concession well before the crisis; was unable to pay its creditors; had petitioned for bankruptcy; and its shareholders were unable or unwilling to make the necessary capital injections to keep the company afloat.[651]

Such financing problems are expected in complex projects, where securing international financing is a risky business and parts of the contract are executed by subcontractors that may be also facing their own financial problems (as was the case with the subcontractor in the current dispute, which also filed for bankruptcy). In this context of high business

[650] Id., para 104.
[651] *Hochtief AG v. Argentine Republic*, ICSID Case No. ARB/07/31, Decision on Liability, 29 December 2014, para 253.

risk and changing (financial) circumstances, structures of adaptive governance are necessary to secure the long-term operation of the contract.

Indeed, in order to address the financial difficulties of the concessionaire, the parties engaged in several renegotiations well before the crisis erupted, and signed several "Cartas de Entendimiento". These early renegotiation agreements had also been subject to disagreements and conflicts, focused to a large extent on the renegotiation process. For example, the Claimant maintained that the public hearing and other procedures had not been observed, and the second "Carta de Entendimiento" had been conditioned on the abandonment of the concessionaire's international claims. The "Cartas de Entendimiento" were terminated when the concessionaire filed for bankruptcy.[652]

The tribunal started its analysis by determining whether the claimant had the right to challenge the contractual renegotiation under the treaty despite the fact that the concessionaire company - to which the investor was a minority shareholder - had consented to the renegotiation with the host state and achieved several transitory agreements to this end. The claimant contended that all the renegotiated deals between the host state and the concessionaire company - approved by the qualified majority of its shareholders and the Board of Directors - were of no relevance for its rights under the treaty,[653] whereas the respondent retorted that by signing the Transitory Agreements the concessionaire had thereby accepted, by the majority of its shareholders, the validity of the renegotiated contracts.

Addressing the question of the Claimant's "reflective loss" as a shareholder in the concessionaire company, the tribunal, instead of examining the rights and obligations of the claimant under regular corporate law,[654] held that the treaty awarded foreign investors "entirely distinct rights, detached from the local realities" of the implementation of the contract by the concessionaire. Despite the fact that the concessionaire company was a separate legal entity responsible for the implementation of the concession, the tribunal considered the question of the rights of the investor under the BIT as entirely different from the corporate governance issues arising from widely established principles of company law.

In a static interpretation of the Claimant's rights and expectations under the treaty, the tribunal held that *Hochtief's* rights as an investor were at the time that it signed the contract (together with the other consortium members) its own rights in relation to the

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[652] Id., paras 120-122.
[653] Or, as was argued in the *Sempra* case, they were "res inter alios acta".
[654] As seemed to be the case in *Sempra*, where the tribunal delved into corporate law by holding that the Claimant cannot be bound by the renegotiation agreement between the licensee and the host state, *because it had not consented to it*.

project, and not its rights *qua* shareholder in the concessionaire company, which was whereby established (as required by the bidding terms). The tribunal thus held that the Claimant's rights under the BIT "date from that time", and did not evolve as a result of its shareholding in the concessionaire company. Among *Hochtief's* rights at that time was the right to be treated fairly and equitably.

This distinction between the time that the claimant signed the agreement establishing the concessionaire company and its subsequent status as a shareholder therein is artificial. The establishment of PdL as the company in charge of the concession did not come as a surprise to the Claimant, but on the contrary, it was a precondition for signing the contract, known to the consortium members already at the time that they bid for the award of the concession.

Moreover, there is an inherent contradiction in the tribunal's legal reasoning regarding the distinct legal rights of the claimant as an investor under the treaty compared to its rights as a shareholder. In particular, it is not clear what the rationale behind the selective application of "legal form" versus "underlying commercial reality" is.[655] Whereas the legal form of the concession was considered relevant to define the "legal stability and predictability" that the investor was entitled to under the treaty, the same legal form was disregarded when it came to defining the specific treaty rights of the claimant, which were based on the "underlying commercial reality" instead. On the contrary, the economic realities that the host state was facing were rejected as legally irrelevant, and the only factor that determined the Respondent's obligations was the "legal form" of the concession.

Evidently such one-sided interpretation of the treaty, whereby the underlying economic realities are considered of legal relevance in favor only of one party, the investor, but legally irrelevant for its counterparty, the host state, only serves to dis-incentivize the investor from also complying with its contractual obligations, if these are not taken into account by an arbitral tribunal judging a treaty claim by disconnecting artificially the treaty from the implementation of the contract.

Similarly, despite the fact that investment treaties aim at protecting also individual shareholders, overlooking the embeddedness of the corporate-governance structure under which the investor operates, in the economic reality of the host state, detaches the concession contract from the local realities and enhances the risk of holdout and opportunism by individual investors. If the host state and the concessionaire are unable to negotiate an amicable solution in the face of changed circumstances out of fear of their agreement being overturned by an individual shareholder, then the very purpose of

[655] Id., paras 156-164.

establishing a new company to operate the public utility under the corporate law of the host state would be invalidated at the arbitral phase.

On the contrary, in the same way that the tribunal considered the Bidding rules as representations and commitments of the host state creating legitimate expectations to the investor, it shall equally take into account the provisions of the Bidding rules establishing obligations for the investor, such as, for example, the establishment of a separate legal entity for the implementation of the concession contract. In order to achieve a consistent and fair legal reasoning, the provisions of the Bidding rules as well as the commercial and economic realities of the concession shall be relevant for both parties, in respect of the interpretative proxy of mutuality, instead of applying selectively for the benefit of the Claimant alone.

As regards the legal evaluation of renegotiation in particular, the tribunal followed the decision in *Total* holding that the contractual renegotiation *per se*, as dictated by the emergency measures, did not constitute a treaty breach. On the contrary, renegotiation was recognized and provided for as a mechanism for contractual adaptation in the agreement itself and was a right accorded to both Parties.[656] It was thus recognized as a legitimate practice of adaptation of the contractual terms even under regular circumstances not amounting to a major economic crisis.

Whereas the tribunal ruled that the renegotiation itself - and pesification, in particular - did not constitute a breach of FET, the manner in which the renegotiation process was implemented, and more specifically Argentina's failure to implement the promised renegotiation process timeously, did. The tribunal noted that the renegotiation "process" was the key element of the Respondent's treaty obligation to treat the investor fairly and equitably by adjusting the terms of the contract to the changed circumstances, as predicted by the law.

Thus, the failure to proceed expeditiously to implement the renegotiated terms agreed with the concessionaire, and especially the continuing delays and abandonment of terms despite the urgency for rebalancing the economic relationship of the parties, amounted to a "complete lack of due process" and, ultimately, a breach of the obligation for fair and equitable treatment. Notably the Argentine judiciary also recognized that "the failed renegotiation process" and particularly the regulator's refusal for more than six years after the enactment of the Emergency law to continue the process, perpetuated "the grave imbalance in the terms of the concession agreement".

[656] See Section 31.2 of the Contract.

Moreover, the tribunal considered that it would have been practicable for the parties to reach a negotiated settlement in 2006 or 2007, when the Claimant was also willing to accept such a settlement. Had an agreement been reached at that point, *Hochtief* would have been *estopped* from bringing a claim under the treaty. Nevertheless, Argentina repudiated the 2006 deal. All the above circumstances considered, the tribunal concluded that it was the process of the renegotiation of the concession contract - and not the renegotiation itself, as a legal consequence of hardship - that breached the treaty standard of FET.[657]

- *Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. v. Argentina*

Another telling example of the regularity of renegotiations as common contractual practice was the *Suez* case (known also as *Aguas Argentinas*).[658] Shortly after the award, through competitive bidding, of the concession contract (that was supposed to run for third years), the investor filed a renegotiation request claiming hardship.

The concessionaire, AASA, claimed that it was facing several difficulties and needed to increase the tariffs to account for local realities. The government accommodated the concessionaire's request for the material modification of the concession contract, and authorized a renegotiation on "various issues of concern", including "the economic and financial parameters of the concession", the incorporation of new areas into the concession, investment deferral, and master plans for waste water and drinking water, among others.

Notably these elements correspond to the aforementioned World Bank study showing that the majority of investor-led renegotiations resulted in more favorable terms for the investor, in particular in these areas that AASA achieved to renegotiate. The renegotiation process between AASA and the Argentine government lasted for two years and concluded with the issuance of a government decree ending the renegotiation.[659] The accommodation of investor's renegotiation requests to address financial difficulties arising from business risks, in combination with the contractual provision that no tariff revision may be used to penalize the investor for past profits,[660] risks rewarding the

[657] See paras 281-288 of the *Hochtief* award.
[658] *Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. v. The Argentine Republic,* ICSID Case No. ARB/03/19, Decision on Liability, 30 July 2010.
[659] Id., paras 38-39.
[660] Not even by imposing windfall taxes in the case of the investor's windfall profits (as was, for example, the case with the windfall taxes that the British government imposed in 1997 on the excessive profits of privatized utilities.

concessionaire's inefficient operation, contradicting those contractual provisions prohibiting tariff reviews as compensation for losses arising from business risks (riesgo empresario), or as compensation for inefficiencies in the delivery of the service.[661]

Despite the accommodation by the government of the investor's request to renegotiate the contract in order to alleviate its financial difficulties (not amounting to "hardship"), the investor did not show the same cooperative spirit, when Argentina was forced to renegotiate its utility contracts due to the severe hardship that the economic crisis inflicted upon the state and the consumers. On the contrary, it invoked the frustration of its "legitimate expectations", as formulated when it decided to invest in Argentina, and insisted on an increase in tariffs in the midst of the crisis.[662]

As in previous cases, the tribunal refused to confer any legal significance to those pre-crisis, investor-led renegotiations. On the contrary, it treated them as a mere factual matter inferring from their implementation that there was a harmonious and cooperative contractual relationship between the parties in the initial stages of the project. More specifically, it held that the significance of these renegotiations and revisions lies not in the details of what the parties discussed and agreed, but rather in what they suggest about the parties' relationship and intentions towards each other.

In the tribunal's view, these early renegotiations clearly showed that any difficulties encountered during the life of the contract could be resolved through consultations and negotiations.[663] Adopting a relational approach on this matter, the tribunal also pointed to the provision of the concession contract requiring that the government and the concessionaire establish and maintain a "fluid relationship" that facilitates the performance of the concession contract.[664] Moreover, it pointed to the contractual provision stipulating that the concessionaire had an obligation to cooperate with the Regulatory Entity, and *vice versa*. The tribunal concluded that it seemed clear from the way in which the parties resolved the hardship that occurred during the first eight years of the concession that such a desired fluid relationship did exist.

On the other hand, Argentina suggested a different interpretation for these early revisions and renegotiations. It argued that the Claimants made an unrealistically low bid in order to win the concession, and thereafter used the revision and renegotiation processes to secure tariff increases, which, had they been included in the original bid, would not have won the Claimants the concession in the first place. The tribunal rejected the

[661] See Article 48 of the Concession Contract. See also para 83 of the award.
[662] See para 44 of the award.
[663] Whether this was ultimately the case with the renegotiations due to the immense economic hardship that Argentina faced is a questionable matter.
[664] Article 5.1 of the Concession Contract.

Respondent's argument holding that Argentina offered no evidence to support this interpretation of the Claimants' requests for renegotiations, and that in any case, the Respondent had the assistance of international consultants in designing the privatization process.[665]

Interpreting FET, the tribunal initially sought guidance in the three elements of Article 31 of the VCLT: the ordinary meaning of the standard; its context; and the object and purpose of the applicable BITs. It rejected the textualist approach noting that the "ordinary meaning" interpretative method is of little assistance in the case of standards with inherent generality, vagueness, and diverse meanings in different cultures and countries. Finding support in the awards in *Saluka*, *MTD*, and *S.D. Myers*, it held that the terms "fair and equitable" can only be interpreted in equally vague terms.

The tribunal similarly rejected the contextualist method, i.e. the context of the standard, according to the second element of Article 31(1), as being of equally little assistance, and did not even analyze it. Left with only the third element of the interpretative guidelines of Article 31(1), the tribunal attempted to interpret "fair and equitable" according to the "object and purpose" of the treaties, and identified as such objects the promotion and protection of investments, but also the economic cooperation between the Contracting States for the purposes of their economic development.

Departing from the "investors' rights" approach, the tribunal found that all the applicable BITs had broader goals than merely granting specific levels of protection to individual investors, and that investor protection was mostly a means to the ends of economic cooperation and development. It concluded that all these broader "objects and purposes" had to be taken into account in defining the meaning of "fair and equitable treatment".

Despite the wider observation that the FET standard has to be interpreted according to its "object and purpose", the tribunal did not find a way to operationalize this interpretative guideline. Left with little assistance from Article 31(1) of the VCLT, the arbitrators asked themselves the question: " by what criteria, standard, or test is an arbitral tribunal to determine whether the specific treatment accorded to the investments of a particular foreign investor in a given context is or is not fair and equitable? "[666]

In an attempt to develop an "operational method" for interpreting FET, the tribunal then turned to the concept of the investor's "legitimate expectations". Without explaining its rationale for choosing the investor's "legitimate expectations" as the operational proxy

[665] See para 40 of the award.
[666] Id., paras 214-221 of the award.

for “fair and equitable treatment”,[667] the tribunal seemed to adopt the common-law approach in that it relied on “precedent” by referring to previous awards that had used the same proxy.[668]

In particular, following the static interpretative criteria of *LG&E*, the tribunal linked “legitimate expectations” with the stability of the legal and business environment in the host state.[669] What was contradictory in the tribunal’s reasoning, though, was that, in identifying what this stability encompassed, it did not take into account the differences in the provisions of the specific contract of *Suez* with Argentina compared to other contracts.

More specifically, the concession’s legal framework in *Suez* did not contain certain elements found in Argentina’s privatized concessions in other sectors, namely the conversion of tariffs to US dollars, and the adjustment of tariffs according to the US Consumer Price Index. Moreover, the tariff setting principles were different. In particular, this concession did not provide for tariffs to cover all costs nor for a reasonable return to the investor, but specified instead that “prices and tariffs shall “tend” to reflect the economic cost of the water and wastewater services including a margin of profit for the Concessionaire, and include all costs arising from the approved expansion plans.”

These differences notwithstanding, and despite the direct bearing that the contract’s framework was supposed to have on the investor’s “expectations”, the tribunal found no difference between the Claimants’ “legitimate expectations” in this case compared with other disputes, where the above elements did form part of the concession’s legal framework. This interpretation of “legitimate expectations” in isolation from the specific contractual framework shows the detachment of the treaty standards from the realities of the implementation of the underlying contracts, and the artificial contract-treaty divide.

In a nutshell, the tribunal conflated the static, classical-contract-law approach with the relational-contract-law approach by relying on the stability of the concession’s legal framework to determine the investor’s “legitimate expectations, but at the same time holding that “beyond the specific words and commitments of the contract and its regulatory framework” and “the elaborate legal framework that the host state designed and enacted”,[670] the Claimants, having entered into a thirty-year “relationship” with the host state, were entitled to expect that Argentina would manage the relationship in a

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[667] As was also pointed out by Arbitrator Nikken in his Separate Opinion. See para 21 of Nikken's Separate Opinion.
[668] Especially the *Tecmed* and *Saluka* cases, as well *MTD vs. Chile*. See paras 221-225 of the award.
[669] See also *Duke Energy Electroquil Partners and Electroquil S.A. v. Republic of Ecuador*, *supra* note ICSID Case No. ARB/04/19, Award, 18 August 2008, para 340.
[670] See para 227 of the *Suez* award. Emphasis added.

"cooperative" manner, meaning that they would "work together" to make the relationship mutually advantageous.

In conclusion, the tribunal decided that Argentina had breached the FET standard by subjecting the concession to renegotiation and refusing to adjust the tariffs in the midst of the crisis, thus frustrating the claimant's legitimate expectations for the legal and business stability of the concession. It thus adopted a classical-law-approach embracing "statism" and discrete instead of dynamic and cooperative obligations, and departed from the more dynamic reasoning of other tribunals that distinguished between renegotiations to address the crisis, which were considered both necessary and legal, and renegotiations conducted post-crisis and against due process, which were found to breach the FET standard.

The tribunal's reasoning was not without objection, though. Remarkable is the dissenting opinion of arbitrator *Pedro Nikken*, who took a more relational approach to interpreting FET. Interpreting the standard in a dynamic way, *Nikken* agreed with the finding on its violation "only for the period following consolidation of the recovery from the economic and social crises" that Argentina suffered, that is, from 2002 onwards.[671] Moreover, he disagreed with the interpretation of "fair and equitable treatment" on the basis of the so-called "legitimate expectations of the investor" as formed "at the time of his or her investment", noting that the "legal stability" requirement has no basis in neither the BITs or in international customary law. On the contrary, "fair and equitable treatment" is in essence a standard of "conduct" or behavior of good governance. This emphasis on "conduct" as the main element of FET is in line with the argument of this thesis about the legal significance of an (often indispensable) renegotiation as process.

Nikken also stressed that Argentina, like any other state, had a duty to take exceptional measures, including the renegotiation of concession contracts, which were unforeseeable and unpredictable when the BITs were adopted, as was the severity of the emergency that the state underwent. In line with the theoretical and empirical predictions of relational contract theory, *Nikken* noted that the renegotiation of long-term concession contracts is far from exceptional, and several witnesses for the claimant admitted that it was normal to renegotiate the original terms of such contracts, when faced with new and unforeseen events.[672]

He pointed in this regard to the renegotiation that the investor itself had requested prior to the crisis, which the host state had accommodated by solving many of the financial problems that the concessionaire was facing due to allegedly new and unforeseen circumstances. Moreover, as regards the crisis-driven renegotiation, according to

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[671] See the Separate Opinion of Arbitrator Pedro Nikken, Retrieved from: http://www.italaw.com/sites/default/files/case-documents/ita0827.pdf, para 1.
[672] Id., paras 2-4, and 26, 36, 47.

statements by representatives of the claimants, there had been no demonstration nor allegation of any coercion whatsoever. On the contrary, the company itself had addressed the government and indicated that the solution to the financial breakdown of the concession "cannot be exclusively a question of tariffs, but must respond in the context of complete restoration of equilibrium involving the different Concession stakeholders." [673]

Last, *Nikken* disagreed with the tribunal's assumption that the concessionaire was coerced into renegotiating, because, had it refused, it would have been accused of violating Article 5.1 of the Concession Contract that obliged both sides to "use all means available to establish and maintain a fluid relationship which would facilitate the discharge of the Concession Agreement." On the contrary, he considered such clause as evidence that the "obligation to renegotiate" did not have as its sole source the Emergency Law but also the "concession contract itself", and thus the concessionaire was not in a position to lawfully refuse to renegotiate.

What is even more important, *Nikken* argued that "the international standard for such contracts in the event of "hardship" aims to impose an obligation on the parties to negotiate an adaptation of the contract to the changed circumstances or the termination of the contract". Regarding "hardship" he referred specifically to the relevant provisions of the UNIDROIT Principles of International Commercial Contracts, and he considered the obligation to renegotiate a corollary of the principle of good faith that should prevail in the execution of any contract.[674]

This statement summarizes perfectly two of the premises of this thesis: first, the relational character of concession contracts, which makes their renegotiation and adaptation indispensable under certain circumstances, and second, the recognition of the general principle of hardship as the international legal standard for evaluating whether a contractual renegotiation constituted a breach of treaty, namely of the FET standard.

- *El Paso Energy International Company v. Argentina*

El Paso was another case where reference to the UNIDROIT Principles was made in the context of a treaty claim, and the tribunal even applied directly the Principles - albeit at the stage of examining the defenses of the host state and not in determining whether the

[673] The reference to the different stakeholders to the concession is evidence of the relational character of concession contracts that involve more stakeholders impacted by their operation (especially the consumers) than simply the two directly contracting parties. See *supra* chapter I.
[674] See para 48 of the Separate Opinion. The direct reference to the contractual provisions in order to determine the legality of renegotiation while evaluating FET, points to the (de facto) strong connection between the treaty and the underlying contract.

FET standard was breached in the first place.[675] With regard to the content of FET, the tribunal identified the standard with the minimum standard of treatment under international law, but at the same time considered its basic touchstone to lie in the legitimate and reasonable expectations of the parties deriving from the obligation of good faith.

Already the reference to the legitimate expectations of the "parties" differentiates the reasoning of this tribunal from previous ones, where the focus was on the legitimate expectations of the investor alone. Departing from such an "investor's rights" approach, the *El Paso* tribunal leaned instead towards the relational proxy of mutuality, at least to the extent that it considered relevant the expectations of both contractual parties in determining the content of the FET standard.

The tribunal noted in this regard the variance in the interpretations of FET that different tribunals had given, ranging from the overly inclusive and static definition in *Tecmed* (that required even the subjective goals of the host state to be made known to the investor beforehand, in order for her to plan her investment in advance),[676] to the much narrower perspective in *Genin*, which required willful bad-faith behavior of the host state in order to find a breach of FET.[677] Despite this variance, the tribunal noted, nevertheless, that there was a common pattern and an overwhelming trend to consider the legitimate and reasonable expectations of the parties, deriving from the obligation of good faith, as the cornerstone of fair and equitable treatment, with *Waste Management II*[678] and *Saluka* recognizing this trend.[679]

Giving its own interpretation of the FET standard, the tribunal took issue with tribunals that had considered the legal and business stability of the concession contract as a central part of fair and equitable treatment, and characterized the requirement that the state's legislation never be changed unrealistic (citing in support the critical remarks of Professor *Vaughan Lowe*).

Taking a relational-contract-theory approach focusing particularly on the dynamism of the concession contact and its framework, the tribunal highlighted that economic and legal life is by nature evolutionary, thus holding that the investor's claims for unaltered capacity payments were untenable. Moreover, the tribunal took a more cautious and relational approach to the concept of the investor's legitimate expectations ruling that "if legitimate expectations of the investor are to be taken into account at all, it has to be

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[675] See *El Paso Energy International Company and the Argentine Republic*, ICSID Case No. ARB/03/15, Award, 31 October 2011.
[676] See *supra* the *Tecmed* award.
[677] See *supra* the *Genin* award.
[678] See *supra Waste Management II*.
[679] See *supra* the *Saluka* award.

stressed that of course all the elements that the investors would like to rely on in order to maximize their benefits, if they are indeed expectations, cannot be considered legitimate and reasonable." [680]

In this context, the tribunal highlighted the importance of "embeddedness" for evaluating the investor's legitimate expectations, by emphasizing that such expectations *vary with the circumstances*, as stated, for example, in *Noble Ventures, Inc. v. Romania*.[681] Moreover, as held in *Generation Ukraine v. Ukraine*, [682] expectations vary depending on the political-economy environment in which the investor operates.[683]

As Argentina argued in *CMS*, along with the premium for investing in an economy in transition come also the risks that such investment bears. By analogy, expectations (among others, for business stability) in a country with a volatile economy, such as Argentina, cannot be the same as in a country with a stable economy.[684] The tribunal also followed the line of reasoning in *Continental* in that it recognized this variance of the standard depending on the socio-economic circumstances, and acceded to the relational proxy of dynamism holding that, if the circumstances change completely, any reasonable investor should expect that the law would also drastically change.[685]

Similarly, the tribunal cited the *Saluka* award, which held that, taken too literally, legal and business stability is unrealistic, and *Parkerings*, maintaining that FET cannot be designed to ensure the immutability of the legal and economic order.[686] It concluded that, as also highlighted by the Permanent Court of International Justice, economic stability cannot be a legitimate expectation of any economic actor. In a similar vein, it took issue with previous tribunals on their one-sided reading of the treaty's Preamble that retained only the element of "stable framework" without taking into account the goals that the

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[680] Id., paras 339-355.

[681] See *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, para 182.

[682] See *Generation Ukraine Inc. v. Ukraine,* ICSID case No. ARB/00/9, Award, 16 September 2003, para 20.37.

[683] See paras 359 et seq. of the *El Paso* award.

[684] The importance of political economy was also pointed out in the *Methanex* case, where the tribunal noted that the investor entered a political economy widely known for its sensitivity to environmental matters, and could thus not pretend to have any expectation for the stability of environmental regulations. See *Methanex v. United States*, UNCITRAL (NAFTA), Final Award, 3 August 2005, para 9 of Part IV - Chapter D.

[685] *Continental Casualty Company v. Argentine Republic*, ICSID Case No. ARB/03/9, Award, 5 September 2008, para 255. The tribunal cited in this regard the decision of the Iran-US Claims Tribunal in *Starrett*, according to which investors have to assume a risk that the country might experience changes of the economic and political system, and even revolution, and that the materialization of any of these risks does not necessarily entail the violation of property rights. See *Starrett Housing Corporation vs. Islamic Republic of Iran*, 4 Iran-U.S. Cl. Trib. Rep. 122, 154 (1983), para 156.

[686] *Parkerings-Compagniet AS v. Republic of Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007, para 332.

state has to pursue as well, especially its obligation to guarantee to its population "maximum effective use of economic resources." [687]

- *Azurix Corp. v. Argentina*

A dispute exemplifying the problem of the production of evidence, particularly regarding claims on opportunistic renegotiations, was *Azurix*.[688] The dispute also shows the complex corporate-governance structures under which the concessionaire company often operates, and the impact those structures have on the sustainability of the concession. Indeed, although the concessionaire company, ABA, was registered in Argentina (as prescribed by the bidding rules), both bidders that won the concession and formed ABA were indirectly controlled by a Delaware-incorporated multinational company, *Azurix*.

In its turn, *Azurix* was a subsidiary of another multinational corporation (that ultimate went bankrupt), *Enron*. Argentina placed particular emphasis on the relationship of *Azurix* with *Enron*. In particular arguing that *Azurix*, as a subsidiary of *Enron*, followed the same aggressive and dubious practices in its bidding for and subsequent operation of the concession. The tribunal devoted only a paragraph on this issue concluding that, for the purposes of the dispute before it and on the basis of the documentation submitted by the parties, nothing had been proven relating to the Enron relationship. It is not clear from this passing reference of the tribunal what the arguments of the parties had been, and whether Enron had indeed exercised effective control over Azurix and the Azurix-controlled concessionaire during the bidding process and the implementation and renegotiation of the contract.

Equally minimal was the tribunal's examination of the claims relating to corruption during the award, implementation, and renegotiation of the concession contract. In its Rejoinder on jurisdiction, Argentina remarked that a section of the concession contract was added "as a result of a renegotiation after the award of the contract". Similarly, the concessionaire's exemption from fines during the first six months of the concession for failure to meet the concession's performance standards was also added "after the award of the concession". Nevertheless, the award held that not enough evidence had been transferred to the tribunal to substantiate those claims.[689]

As regards the judgment on FET, the tribunal engaged in a textualist interpretation based on Article 31(1) of the VCLT. Influenced at the same time, though, from the common-

[687] See para 369 of the *El Paso* award.
[688] *Azurix Corp. v. the Argentine Republic*, ICSID Case No. ARB/01/12, Award, 14 July 2006.
[689] See paras 55-56 of the *Azurix* award.

law approach, and especially its emphasis on precedent, it found that with the exception of *Genin*, there was a common thread in recent awards holding that FET was an objective obligation going beyond the international minimum standard and encompassing the investor's legitimate expectations. On the basis of these considerations, the tribunal held that it was "struck by the conduct of the Province after the Claimant gave notice of termination of the Concession Agreement" and the refusal of the Province to accept such request, as well as the politicization of the tariff regime in light of the elections that were approaching, and consequently found the Respondent to have breaches its treaty obligation to treat the investor fairly and equitably.[690]

The tribunal did not engage, though, in a causation analysis of the reasons that were determinative of ABA's incapability of securing financing and meeting its commercial obligations for the operation of the concession. In particular, it was not clear from the tribunal's (very brief) reasoning whether it was the materialization of the regulatory risks or, on the contrary, the commercial risks that was the decisive factor for the failure of the concessionaire to obtain the financing that it had committed to secure when it bid for and won the concession.

Similarly, the tribunal failed to examine the other side of the renegotiation coin, that is, the request of the concessionaire to renegotiate shortly after the award of the contract through competitive bidding, as well as its difficulties to secure financing.[691] Similarly, it did not evaluate the fact that the regulator had requested ABA to present a detailed cost study justifying the changes in its cost structure and the potential consequences of the tariff review on the delivery of the service and the users,[692] and ABA's denial to procure the requested study, which resulted in the dismissal of its renegotiation request.[693]

Dismissing such unjustified renegotiation requests is in line with the predictions of the World Bank study on the renegotiation of concession contracts that the respondent explicitly referred to,[694] which advises host states not to yield to opportunistic renegotiation requests and hold instead the concessionaires accountable to their bids. Of course, such accountability can well be frustrated if the investor has the option to

[690] Id., paras 372-374.
[691] OPIC itself alluded to the reality of renegotiations as common practices of the parties. See id., para 162 on OPIC's statement that "the failure to reach an agreement to implement modifications to the concession to restore a sustainable situation for ABA precludes us from moving forward with potential financing".
[692] Another element of the renegotiation process – consistent with the relational-contract approach and the importance of more stakeholders in the governance of the contract – was the requirement that the request would be debated on a public hearing, which shows that the tariff review was far from automatic – as the claimant argued – but, on the contrary, was the result of a cooperative process. The claimant's argument on the automaticity of the tariff review was also contested in *PSEG v. Turkey*, where the respondent retorted that the Ministry had the discretion to approve or disapprove the revised tariff plan. See para 45 of the PSEG award.
[693] See para 109 of the *Azurix* award.
[694] Id., para 210.

challenge the dismissal of its request before an arbitral tribunal by bringing a claim of breach of the treaty, namely FET, or of expropriation. The way for tribunals to tackle this transaction cost of opportunism and moral hazard is to apply a relational-contract reasoning for interpreting FET by taking into account also the investor's conduct during a renegotiation, as happened in the *Biwater* case, examined below.

2. Other renegotiation cases

The disputes that arose from the Argentine crisis constituted indeed the big boom of cases where the issue of contractual renegotiations was brought before arbitral tribunals called to judge a treaty claim, and particularly the breach of the fair and equitable treatment standard. Despite its limited visibility under international law (due to a number of factors, especially the exclusive right of the investor to take recourse to international arbitration and the artificial distinction between the treaty and the underlying contract) the issue of contractual renegotiations has also been at the center of other disputes that did not arise from the Argentine economic crisis.

For the sake of the completeness of the analysis, and in order to demonstrate that the renegotiation of concession contracts is a frequent and multifaceted phenomenon that can occur also outside of a crisis context, and in a variety of countries with diverse cultures and socio-economic environments, the following section touches upon some of those cases.

- *Biwater Gauff LtD v. Tanzania*

The dispute between *Biwater* and Tanzania is a telling example of how a state can resist an opportunistic renegotiation request, and how a treaty tribunal can assist the host state in its efforts to implement such a good governance practice, by dis-incentivizing opportunistic behavior and the potential use of arbitration as an insurance mechanism for bad business decisions.[695]

There are two elements that stand out in *Biwater*, which support the governance design proposed herein for the renegotiation of concession contracts. The first is the use of an independent mediator to conduct the renegotiation process in an orderly, transparent, and

[695] *Biwater Gauff LtD vs. United Republic of Tanzania*, ICSID Case No. ARB/05/22, Award, 24 July 2008.

impartial manner, and the ensuing possibility of using the relevant evidence at a later, arbitral dispute. The second is the holistic reasoning of the tribunal, in terms of engaging both in a legal evaluation of the renegotiation process and in a causation analysis in order to establish whether the claimant's losses were the result of the host state's alleged treaty breaches or the investor's own misconduct.

Despite the fact that "causation" was taken into account only at the stage of determining damages and not already at the phase of determining whether there was a breach of FET in the first place, the fact that the tribunal engaged with an examination of the investor's own conduct is an encouraging sign for the use of the proxy of mutuality for interpreting investment treaties.

Assessing the facts of the case, the tribunal took note of the poor contractual performance of *City Water*, the concessionaire. It observed in particular that the company failed to achieve the goals prescribed in the lease contract and "cited the finding of the expert mediator during the renegotiation testifying" that "in an overriding way, *City Water's* performance had been pretty poor…the performance, it was pretty much regarded by everybody, really, that their performance had not been very good at all". Moreover, the evidence showed that the foreign investor, *Biwater*, had seriously underestimated the amplitude of the task of providing its services in the concession area, especially by submitting a poorly structured bid, and then failing to perform as anticipated, thus encountering serious financial problems at a very early stage.[696]

Examining the evidence regarding the concessionaire's request to renegotiate its contract with the host state, the tribunal noted that the severe financial problems of *City Water* were continuing. Under these circumstances, the majority shareholder in *Biwater* had written to the Minister recommending options for the rescue of the project that were "outside of the contractual methods of review", claiming that *City Water* was not viable with its then current cost base and revenue projections.

According to the evidence, the Tanzanian Minister had expressed his full agreement that *City Water* was in serious financial problems, but believed that the solution lied with the injection of equity and the improvement of revenue collection. He also retorted that the options that *Biwater* had put forward, amounted to a renegotiation of the initial (and recently concluded) contract between the state and the investor.

In light of these circumstances, the Minister took an orderly approach to renegotiation and aimed to "regulate the process" noting that *Biwater's* proposals were based on a new financial model departing from the original contract. He therefore invited *Biwater* to file

[696] Id., paras 148-149.

"a formal renegotiation request", in order for the Ministry to subsequently determine the process under which the renegotiation would take place and its timing. *Biwater* indeed submitted a formal request for renegotiation.

Equally important evidence that the tribunal gathered and evaluated, was the internal communication between the top management of *City Water* and *Biwater* regarding the strategies that the affiliated companies were planning to deploy *to secure gains during the renegotiation.* The exchanged emails were suggesting that the investors took drastic action to the extent of cutting all payments to the regulator immediately until the contract was renegotiated, and that, unless they got the tariff increase they had requested, they would force the government's hand, for example through negative publicity to embarrass the government, especially by taking advantage of the forthcoming national elections.[697]

The renegotiation process began shortly after the investor's request, but the parties were in a difficult position because "the meeting was contentious in that after eighteen months into a ten year management contract, *City Water* was alleged to have achieved little, and overall revenue from tariff collection had gone down substantially." [698] On the pros of the process - and in stark departure from the previously examined cases (and the majority of renegotiation cases in general) - the renegotiation process was conducted with the presence and assistance of an independent and international, expert mediator, recommended by the World Bank, Dr. *Ballance*.

The contribution of the mediator to the transparent implementation of the renegotiation process and the gathering of evidence at this stage was of crucial importance for the equally transparent and fair adjudication of the case in the subsequent, arbitral proceedings. Among others, the mediator prepared a report setting forth a plan for substantive negotiations, observing *inter alia* that *City Water*'s own performance had contributed to its poor financial situation, and the company was not in compliance with the terms of the lease contract.

The renegotiation between *City Water* and the Tanzanian authorities ultimately failed. Upon failure of the renegotiation process, the government decided that the contract should be terminated. *Biwater* reacted by notifying the Republic that they considered the host state to have breached its obligations under the UK-Tanzania BIT, and that all the rights of the company to pursue claims were preserved, including the right to file a request for arbitration with ICSID.

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[697] Id., paras 179-183. This evidence shows (once again) that opportunism can work both ways, including strategic efforts to capitalize on potential gains from a forthcoming national election.
[698] Id., para 185.

Tanzania claimed that ICSID lacked jurisdiction, because there was no protected "investment" in that case, arguing that a protected investment is one undertaken on the basis of a reasonable expectation of profit, and not a "loss leader" like the *Biwater's* project, wherein the criteria of "risk" and "substantial commitment" were not satisfied. The tribunal did not accept the respondent's view, instead assuming jurisdiction by adopting a broad definition of investment as including "every kind of asset".[699]

Given the high profile and the importance of the case, several *amici curiae* submitted briefs to the tribunal, a key theme of which was the "responsibility of the investor". The *amici* cited a dictum in the *Maffezini* case noting that "Bilateral Investment Treaties are not insurance policies against bad business judgments".[700] They equally argued that "investors are expected to be intelligent and aware of the environment in which they are investing".[701]

Similarly, the *amici* briefs referred to the investor's duty of due diligence citing the passage from *Waste Management v. Mexico*, which stated that "it is not the function of international law […] to eliminate the normal commercial risks of a foreign investor, or to place on Mexico the burden of compensating for the failure of a business plan which was dependent for its success on unsustainable assumptions about customer uptake and contractual performance." [702] Moreover, the *amici* emphasized the duty of good faith binding equally host states, through the FET standard, and investors, through the general principle of law applying also to their behavior.[703]

As with the vast majority of renegotiation cases, the main claim in *Biwater* was the breach of the FET standard. Departing from previous case law, though, the tribunal took into account countervailing factors, namely the responsibility of the foreign investor, both in terms of due diligence and subsequent conduct, in order to decide whether Tanzania had violated the standard. To this end, it placed particular emphasis on the limits to legitimate expectations in circumstances where an investor itself had taken on risks by entering a particular investment environment, and the relevance of the parties' respective rights and obligations, as stipulated in the investment agreement.[704]

Regarding the investor's claim that the Republic failed to deal with requests to adjust the terms of the contract,[705] the tribunal noted that the contract did not entitle *City Water* to a

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[699] See para 242 of the *Biwater* award.
[700] See *supra Maffezini* award, para 64.
[701] See *supra Genin* award, para 348.
[702] See *supra Waste Management Inc. v. United Mexican State*s, para 177.
[703] See para 378 of the *Biwater* award.
[704] Id., para 601.
[705]Or, as the Respondent put it, to de-risk the contract by shifting to the host state risks that the investor had assumed during the bidding process. Id., para 637.

"general needs" review, and that Tanzania was under no legal obligation to make the radical changes that the investor requested, yet the Republic accepted to enter into renegotiations in a demonstration of good faith. The tribunal thus concluded that no breach of the FET standard had occurred as a result of the renegotiation process between the investor and the host state.[706]

The *Biwater* award in presents several merits regarding the evaluation of renegotiation against the background of a claim for breach of FET. Among those is the thorough examination of evidence on the entire evolution of the renegotiation process, referring even to the companies' internal correspondence and the planning of their renegotiation strategies. Another, interrelated advantage was the assignment of the renegotiation process to mediation. The independent expert in charge of directing and monitoring renegotiation was a key factor in gathering, transparently, impartially and in a depoliticized way, crucial evidence that was used later in the arbitral proceeding. Last, an important lesson learned from *Biwater* is the strong connection that the tribunal drew between contract and treaty claims in evaluating the FET claim showing that treaty standards are intrinsically related to the way the contract and the relationship of the parties had evolved, and the conduct of the investor shall also be taken equally into account for determining its "legitimate expectations" under the treaty.

- *Fraport AG Frankfurt Airport Services Worldwide v. the Philippines*

Despite falling outside the scope of this thesis (covering concession contracts in the energy sector)[707] the *Fraport* dispute exemplifies two issues lying at the core of this thesis: the renegotiation as a two-sided game, and the complex corporate governance practices frequently acting on the backstage as a driver of rent-seeking renegotiations undermining the viability of the concession. The case is also noteworthy in that the tribunal did not proceed with a judgment on FET evaluating, instead, the investor's

[706] Id., paras 646, 651, 675.
[707] Thus excluding as well the renegotiations on the basis of equity in the natural resources sector, such as the cases of *Occidental* and *Burlington* v. Ecuador. These renegotiations present different characteristics and challenges and have different drivers, namely the adjustment of royalties in favor of the host state on the basis of equity. On the contrary, the emphasis herein is on renegotiations driven by the transaction costs of bounded rationality and opportunism or driven by hardship, which are concerns particularly distinct in the case of concession contracts in the energy sector.

renegotiating practices already when determining whether *Fraport* had an “investment” in the first place.[708]

The *Fraport* dispute is also an example of the connection between renegotiation and the legality of an investment entitled to protection under a BIT. The series of renegotiations that took place between the foreign investor and the Philippines government show that renegotiation is not the exception but a “common practice” for parties to complex, long-term contracts. More importantly, the case serves as an example of an investor-led renegotiation aiming to manipulate the domestic law of the host state in order to cure the illegality of the contrary and be entitled to protection under the treaty.

More specifically, the investor submitted a renegotiation request only a few months after the contract was signed pursuant to the bidding process stipulated in the Philippine legislation, claiming difficulties to secure financing from international lenders. These difficulties seem hardly unpredictable, as they were at the core of the challenge that another bidder, AECD, had brought against the concessionaire, PIATCO. Nevertheless, the government accepted to renegotiate pending the validation of the original contract by the incumbent regulatory authorities due to AECD’s challenge, and concluded with PIATCO the “Amended and Restated Concession Agreement” (herein, ARCA).

The renegotiated terms were onerous for the government resulting *inter alia* in the conversion of the passenger fee from pesos to dollars, and the government’s guarantee that, in the event of PIATCO’s default, the government would take over the concession, compensate PIATCO, and assume all its liabilities. The government also guaranteed that the ARCA was legal and would take precedence over the bidding documents, in case of conflict.

It ensues from these amendments that the renegotiation aimed to cure the legal pathologies of the contract, and secure better terms for the investor, making possible its debt-financing. Moreover, the renegotiation process was politicized, as the President issued a Memorandum stating the government’s commitment to fulfill all its contractual obligations, and inviting the regulators to engage their full cooperation in ensuring the completion of the project.[709] Such political interference with the regulatory process illustrates the concerns exposed above, namely the bypassing of the regulator, the

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[708] *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippine*s, ICSID Case No. ARB/03/25, Award, 16 August 2007.
[709] Id., para 106.

preemption of its decision, and the weakening of the democratic system of checks and balances during the award and implementation of concession contracts.[710]

At the time that *Fraport* resolved to invest in the PIATCO project, all the aforementioned legal issues were still open. The legal and financial due diligence reviews submitted to *Fraport* pointed to these open issues as well as the problems that would result from a potential non-compliance with the Philippine Constitution and legislation. Despite these pending legal issues, *Fraport* decided to invest in PIATCO, and even entered in a series of secret shareholder agreements [711] to secure the actual control of PIATCO in violation of the Philippine Constitution.[712]

In order to decide on its jurisdiction *ratione materiae*, the Tribunal interpreted a common provision in the Philippines-German BIT, pursuant to which an asset qualifies as an "investment", thus falling under the jurisdiction of the arbitral tribunal, only when "accepted in accordance with the respective laws and regulations of either contracting state." [713] Compliance with domestic laws thus has not only municipal but also international legal effects. While the BIT is an international instrument, its Articles providing for the legality of an investment as a prerequisite for jurisdiction commend a *renvoi* to national law. Thus, failure to abide by the latter produces direct legal effects also at the international level.

Examining the shareholder agreements and other internal documents (produced under persistent [714] requests from the President of the Tribunal) the tribunal found that *Fraport* was "consciously, intentionally, and covertly structuring its investment in a way in which it knew to be in violation of the Anti-Dummy Law." Despite having been advised and plainly understanding this, *Fraport* secretly designed its investment so as to obtain and keep management and control in violation of the Philippine law. The tribunal noted in this regard that the BIT explicitly and emphatically required that an investment be in compliance with the laws of the host state, in order to qualify for protection under the treaty.

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[710] President Estrada also directly interfered with AECD's lawsuit by summoning PIATCO's competitor to meet with him. AECD withdrew its pending challenge to the award at the express request of the President, despite continuing warnings and discontent about the PIATCO's ability to meet minimum equity requirements and finance its bid.
[711] Despite their secrecy and confidentiality, the agreements were formal and internally enforceable, with any disputes between the shareholders submitted to arbitration under the ICC rules.
[712] Another rule that the concessionaire breached referred to the prohibition of exclusivity in the operation of the utility. The Supplements to the amended contract assigned a right of exclusivity to the concessionaire, in violation of the Philippine Constitution providing that franchises, authorizations and certifications for the operation of public utilities shall not be exclusive.
[713] Germany-Philippines BIT (1997), Article 1.
[714] The President's requests for the production of evidence were persistent even for those agreements not covered by confidentiality.

Moreover, following PIATCO's footsteps, *Fraport* also engaged in renegotiations of the concession contract to resolve the illegality of the ARCA and to address the continuous concerns of the Senior Lenders. In a recognition of the proxy of mutuality, *Fraport* described renegotiation as "a normal bargaining situation where one party agrees to certain changes in consideration of the agreement of the other party to other changes" and the *process* as "friendly and cooperative". Nevertheless, while proposing several amendments itself, the concessionaire refused to accept the amendments that the Philippine government proposed, and threatened to abandon the concession invoking "hardship" due to a substantial change in traffic projections following the September 11 events and the resulting dismal forecasts of the project's economics.[715]

The government rejoined that the concessionaire had been initiating yearly renegotiations since the very beginning of the project, all of which were questioned on legal, political, economic, and moral grounds, while there had also been grievances about the way the company was implementing the concession. The government contended that all these problems had been explained to the company's lawyers on several occasions, and concluded that the reopening of the ARCA was a "yearly activity" for the concessionaire and that its denial to accept the government's renegotiation proposals contradicted its previous actions.

The last claim of the government, regarding the contradiction of the investor's conduct with its previous actions, refers to the legal issue of "estoppel". The doctrine of "non concedit venire contra factum proprium" or of the protection of "legitimate expectations" is a general principle of contract law.[716] As such, it applies equally to both contracting parties and regulates their conduct during the implementation and evolution of their contractual relationship.[717] This means that the investor and the state alike are expected to act in good faith and in a consistent manner all the way through the execution of their contract.

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[715] To which extent the concessionaire is entitled to claiming the defence of hardship to evade its contractual obligations while the same defence is recognized only limited for the state is a question that will be examined further below, in the review of the cases ensuing from the Argentine economic crisis.
[716] *Thunderbird v. Mexico*, UNCITRAL, Separate Opinion of Arbitrator Thomas Wälde, 2006, para 27. The arbitrator also refers to *Trazegnies*, who examined the principle in light of its Roman law antecedents and in particular Latin American, namely Argentine and Peruvian practice: "no es admissible que un contratante o parte en general actue unas veces en un sentido y otras en otro, afirme ciertos hechos en una situación y los niegue en otra, reconozca y acepte ciertas interpretaciones…y las deconozca en otra similar, simplemente porque en una le conviene y en otra no le conviene". See Trazegnies, F. (2005*), La verdad construida, algunas reflexiones heterodoxas sobre la interpretacion legal,* Themis, Revista de Derecho, 51: 19, at 38-39.
[717] The contractual dimension of the principle is without prejudice to the question on its potential administrative-law function, whereby estoppel restricts a state from acting against its previous conduct, if the latter has created legitimate expectations to the investor.

Indeed, in line with the proxy of mutuality, arbitrator *Cremades* emphasized the bilateral commitment, or mutual operation of *estoppel*, in his Dissenting Opinion, noting that an investor contravening the law of the host state must expect to suffer the consequences of her behavior. He added that the principle of legality in investment arbitration, like the principles of *pacta sunt servanda* and good faith, applies equally to both parties, and the purpose of the Tribunal is to determine the legality of the conduct of the host state "and the investor" under the applicable law.[718]

While the tribunal held that "principles of fairness should require the government to be estopped from raising violations of its own law as a jurisdictional defense when it knowingly overlooked them and endorsed an investment that was not in compliance with its law." [719] It also endorsed, in principle, the investor's argument that "the cumulative actions of a host government may constitute an informal acceptance of the investor's illegal act." [720]

However, in light of the particular facts of the case, the tribunal found that a covert agreement, by definition unknown to the government, cannot be any basis for estoppel. The evidence showed that *Fraport* concealed all its illegal corporate-governance actions from the host state.[721] As a result, the latter could not have taken any legal action against the foreign investor. Instead, it renegotiated with the concessionaire in good faith.

The lack of transparency and the withholding of material information from the part of the concessionaire illustrates the common problem of *information asymmetries* between the parties to a Public-Private Partnership, as described above. The *Fraport* case is a telling example of the role of foreign corporate governance in the operation of a concession contract and the way transnational corporate-governance practices affect the renegotiation of the contract, even behind the scenes.

In conclusion, the renegotiations between the concessionaire and the host state in the *Fraport* case exemplify a series of issues analyzed above: the tangible risk of renegotiations driven by rent seeking and taking advantage of the bilateral-dependency condition; the difficulties in good-faith cooperation due to transnational corporate governance practices favoring the withholding of information by the foreign investor,

[718] Dissenting Opinion of Mr. Bernardo M. Cremades, para 36.
[719] See Lim, K. (2011-2012), Upholding Corrupt Investors' Claims Against Complicit or Compliant Host States - Where Angels Should *not* Fear to Tread, Yearbook on International Investment Law & Policy 2011/2012: 601.
[720] See paras 387, 392 of the *Fraport* award.
[721] Id., para 347.

thus creating information asymmetries between the latter and the host state; and the role of *estoppel* impacting the conduct of both the host state and the investor.[722]

Last but not least, the case also contributes to drawing conclusions about the value of mediation in conducting the renegotiation process.[723] If the responsibility for the latter had been assigned to independent mediators, the process would have been in all likelihood more transparent. Moreover, should the evidence and the results of the mediation process be taken into account in a subsequent arbitral proceeding, the investor may have been more reluctant to conceal material information, in light of potential adverse consequences to be drawn from such behavior in the arbitral phase. Overall, as demonstrated in the following part, mediation can have a positive impact on the successful outcome of a transparent, cooperative, and less politicized renegotiation process.

[722] For a more detailed analysis of the connection between *estoppel* (or the doctrine of legitimate expectations) with renegotiation, see the previous section.
[723] The value of mediation was also emphasized by the Philippine Supreme Court, which ordered the parties to explore the possibility of mediation or arbitration.

The previous chapters proposed a governance design for the interpretation of the FET standard in disputes arising from the renegotiation of "internationalized" concession contracts, implemented under the auspices of investment treaties. The analysis started with the doctrinal and empirical examination of the relational nature of such underlying contracts, then moved to the proof of the inextricable link between those contracts and the overarching treaties, and concluded with the argumentation for the use of relational contract principles to the interpretation of treaty standards, namely FET, corroborated by the reasoning of certain arbitral tribunals.

This section takes a step back from the current state of affairs, proposing instead some prescriptions for improving the adjudication of regulatory disputes in a way that economizes better on the transaction costs of bounded rationality and opportunism. To this end, mediation has the potential of making renegotiations more "observable" thus alleviating information asymmetries between the parties, and more "verifiable" to the court, thus making them visible in international law. Similarly, penalty default rules serve the purpose of tackling information asymmetries potentially abused by one of the parties for the sake of shifting rents to its benefit. Last, the third part touches upon the politics of international arbitration and the arbitrators' accountability.

1. Mediation as a means for renegotiation and production of evidence

Mediation is a mechanism by definition relational. Taking the focus away from the legal "rights" of the parties, as laid down in the "four corners" of their agreement, mediation brings at the forefront the parties' "interests" instead aiming to facilitate the early settlement of a difference before it escalates into a dispute.[724] In the context of concession contracts, mediation can be a valuable mechanism for their renegotiation and adaptation in a fair and equitable manner.

Before analyzing the specific advantages of assigning the renegotiation process to mediation (as happened in the *Biwater* case), it is useful to point to the particular characteristics of mediation, which make it an example of the application of relational

[724] On the difference between rights- and interest- disputes, see http://www.arbitrationcouncil.org/en/post/71/Rights-vs-Interests-Disputes-Whats-the-Difference. On mediation's focus on interests, see http://www.pon.harvard.edu/daily/mediation/mediation-focus-on-interests-not-rights/

contract theory to the resolution of investor-state disputes. Unlike arbitration, mediation is not conflictual. As *Salacuse* has noted, "neither the aim nor the consequence of arbitration is to repair a broken business relationship." [725]

Even investors themselves have pointed to the pains of going through a long arbitral proceeding, with the CEO of *Metalclad* wishing – despite winning the case against Mexico – that his company had relied upon its "political options" to resolve the dispute.[726] *Bottini* has confirmed from his own experience that "at least for some" of the claimants against Argentina "conciliation could have been a valuable alternative to pursue the resolution of these claims." [727]

Mediation bears all the characteristics of a relational-contract-law mechanism. It offers investors and states the possibility of resolving their disputes themselves and preserving a valuable business relationship. It also encourages the parties to develop trust in one another and share important information, including their most important interests to arrive at a solution.

Mediation's flexibility also allows for the involvement of third parties in the process, especially those stakeholders impacted by the (negative) externalities of the contract. The process is not merely facilitative, though, nor focused exclusively on the parties' wider interests in collaborating, but is also evaluative and involves the consideration of legal rights and norms.[728] This combination of relational facilitation with the legal evaluation of the parties' rights is of particular relevance for contractual renegotiations, where the collaboration of the parties to adapt their contract should be combined with the evaluation of their rights and obligations under the contract.

Mediation is not just a theoretical possibility, but has been recognized as an important method for the resolution of investor-state disputes by several stakeholders, including international organizations, such as UNCTAD.[729] Moreover, there have been efforts to operationalize the proposal, for example through the use of the IBA Rules for Investor-

[725] Salacuse, J. (2007), Is There a Better Way? Alternative Methods of Treaty Based Investor-State Dispute Resolution, Fordham International Law Journal, 31 (1): 138, at 155.
[726] Coe, J. (2009), *Should Mediation of Investment Disputes Be Encouraged; and If So, by Whom and How?*, in: (Ed.) Rovine, A., *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers,* Brill On the efficacy of relational contracts in striking solutions to problems that the parties are facing during the implementation of their contract, even in times of crisis, see Post, A., *supra* 103
[727] Bottini, G. & Lavista, V. (2009), *Conciliation and BITs*, in: (Ed.) Rovine, A., *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers*, Brill.
[728] Schneider, K. & Welsh, N. (2014), *Integrating Mediation into Investor-State Arbitration*, Retrieved from: https://www.transnational-dispute-management.com/article.asp?key=2080, at 15.
[729] UNCTAD (2013), *Reform of Investor State Dispute Settlement: In Search of a Roadmap*, Retrieved from: http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4_en.pdf

State Mediation. The process has even been set as a prerequisite to arbitration or litigation through its integration into many contracts by means of the so-called “step clauses.” [730]

Mediation’s success has been proved in practice, even in cases where arbitration was not able to give a satisfactory solution to complex (and often politically sensitive) matters. A prominent example has been the mediated settlement that Argentina recently reached with the *Elliott* hedge fund and other bondholders. What had not been achieved in courts for years was achieved with the intervention of a mediator, who managed to strike a deal allowing Argentina to rejoin the global financial markets after being locked out for fifteen years.[731]

In order to reap the benefits of mediation, though, the process has to be integrated into the system of investor-state dispute settlement. Similarly, if mediation is to contribute to economizing on opportunism and bounded rationality often driving the renegotiation of a concession contract, its effects, especially the relevant evidence gathered thereby, should be taken into account at a later arbitral dispute.

In the specific context of the renegotiation of concession contracts, mediation can be of decisive importance, resembling the role of mandatory conciliation. In particular, the renegotiation process itself should be assigned to an independent mediator, who would assist the parties both in preventing its politicization and – crucially – in making renegotiation more transparent by gathering evidence that could have a decisive impact on the outcome of a potential later arbitral dispute arising from the renegotiation of their contract.

The *Biwater* case exemplified the argument that the evidence produced during the mediated renegotiation process can determine the very outcome of a subsequent arbitral dispute, and, in a backward induction, also the parties’ incentives. The case can serve as a guide on how contractual renegotiations should be conducted, and more importantly how arbitrators should take the renegotiation process and the evidence produced therein into account when judging whether there was a breach of the treaty, namely of the FET standard.

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[730] Sussman (2014), *The Advantages of Mediation and the Special Challenges to its Utilization in Investor State Disputes,* Retrieved from: https://www.transnational-dispute-management.com/article.asp?key=208, at 2.

[731] https://www.nytimes.com/2016/04/25/business/dealbook/how-argentina-settled-a-billion-dollar-debt-dispute-with-hedge-funds.html?_r=0

2. Penalty default rules and adverse inferences as evidentiary standards

a) Introduction

Any proposals on the proper interpretative rules that arbitral tribunals should apply to impart meaning to the vague treaty standards would be both incomplete and ineffective without similar recommendations on the proper, evidentiary standards for the resolution of complex disputes involving the transaction costs of bounded rationality and opportunism, as is the case with disputes arising from the renegotiation of concession contracts.

In this context, the application of evidentiary rules tackling those transaction costs is indispensable to achieve an efficient and balanced adjudication of an investor-state dispute. Drawing from transaction cost economics and relational contract theory, as well as the actual practice of arbitral tribunals, this section examines the potential of "adverse inferences" to force the disclosure of material information - thus alleviating bounded rationality and information asymmetries - and of "penalty default rules" to attach consequences to the strategic withholding of material evidence - thus limiting the appetite for opportunistic behavior.

Before examining the actual cases that have made use of adverse inferences, it is important to analyze the theory supporting the use of such transaction-cost economizing evidentiary rules. This section takes a step closer to the backward-induction perspective by moving away from the interpretative phase and diving instead into the waters of contract (or more accurately, treaty) design. It builds to this end on the pioneering research of Professors *Scott* and *Triantis* on anticipating litigation in contract design, as well as Professor *van Aaken's* analysis of the trade-off between commitment and flexibility in international investment law.

b) Anticipating litigation in contract design

Scott and *Triantis* advance a theory of contract design in a world of costly litigation. Such design is, by analogy, particularly important also in the world of investor-state dispute settlement, which entails significantly high litigation costs, especially at the evidentiary stage. This section translates the tenets of contract theory into prescriptions for the design of international investment treaties operating in the shadow of costly litigation. In particular, the purpose of the trade-off between "front-end" and "back-end" costs is to make the most efficient choice between "rules" and "standards" in investment treaties.

Efficiency is defined herein as the cost-effectiveness of litigation, resulting from a "maximization of the incentive bang for the contracting-cost buck." [732]

In addition, this section uses the analysis of Professors *Ayres* and *Gertner*, in order to make an analogy between the penalty default rules used in contract law and adverse inferences used in investment treaty arbitration. It similarly reviews the case law of arbitral tribunals that have deployed such inferences, both in commercial and investment arbitration. The objective of penalty defaults and adverse inferences is also efficiency, defined widely as to encompass behavioral factors leading to a better alignment of the parties' incentives.

As analysed above, treaty interpretation is the result of the trade-off between the "front-end" costs of contracting, i.e. the costs of designing a treaty based on concrete and complete rules, and the "back-end" costs of adjudicating a dispute based on vague, inherently incomplete standards delegating wide interpretative authority to the adjudicators. As argued herein, the trade-off in investment treaties has been largely resolved in favor of standards assigning the election of the proxies for their interpretation to arbitrators.

The central pillar of *Scott's* and *Triantis'* study is the weighing of contracting costs against the "incentives" that they produce, or otherwise, "the incentive bang for the contracting-cost buck". In this context, the authors examine the determinants of "front-end" transaction costs and "back-end" enforcement costs, focusing particularly on the rules of evidence and procedure that significantly constrain *ex post* litigation costs, thus offering opportunities to the parties to achieve an efficient trade-off between the two types of costs. By the same token, they explore how parties choose between precise and vague terms to lower contracting costs by assigning the choice of "proxies" either to themselves (i.e. the "front end" of the contracting process), or the court (i.e. the "back end" of the process).

Scott's and *Triantis'* model can apply by analogy in the field of international investment treaties, subject to the necessary adaptations to the particular context of state contracts and international treaties (which involve, nevertheless, a commercial party, thus resembling commercial contracts in this regard). In particular, the model rests on the assumption that there are no information asymmetries between the parties - an assumption standing in opposition to the reality of concession contracts. Moreover, it does not factor in the complexities of public contracting, where the efficient choice

[732] See Scott, R. & Triantis, G. *supra* note 111, at 821, 823.

between standards and rules is not as straightforward as in commercial contracts, but is, on the contrary, complicated by agency and public-choice considerations.[733]

Scott's and *Triantis'* theory offers valuable insights into the determinants of choosing vague standards over precise rules. On the other hand, *Ayres'* and *Gertner's* analysis of penalty default rules can produce significant policy effects for the practice of arbitral tribunals, and the alignment of the disputing parties' incentives. In particular, the establishment of penalty defaults in investment arbitration would force the disclosure of evidence on the renegotiation of the concession contract that gave rise to the treaty dispute.

Indeed, the empirical reality shows that the verifiability of information to the court is not a stylized process, but results instead from the motion of self-interested parties prone to manipulating evidence in order to establish a relative (and not absolute) truth to the court, based on probabilities. Although the evidentiary task of the tribunal is limited by its inability to observe the disputed facts directly, it is nevertheless broader if the parties have used standards (instead of precise rules) to express their obligations. In the standards scenario, the tribunal also has to select the proxies for defining the standard before examining the evidence proving the content of those proxies. Transposing this contractual logic to the domain of investment treaties, the concept of "legitimate expectations", which is not stipulated in the treaty but is instead the product of interpretative fiat, can be considered a proxy for imparting content to the standard of “fair and equitable treatment”.

Scott and *Triantis* also argue that the costs of proof depend on the proxies used and the evidence deployed to establish the presence or absence of such proxies.[734] *Ayres'* and *Gertner's* analysis on penalty defaults brings (even if only indirectly) into the picture two additional transaction costs, bounded rationality and opportunism. In the more complex context of investor-state contracts and the ensuing arbitration, the goal is to strike an efficient trade-off between “front-end” and “back-end” transaction costs in a way that also economizes on the behavioral transaction costs of bounded rationality and opportunism, thus contributing to the alignment of the parties' incentives.

As the process of litigation is a game, where self-interested parties have their proper evidentiary strategies, the use of penalty default rules has the potential to force the parties to cooperate during the arbitral proceedings, otherwise face penalties for the non-disclosure of material information. By extension, penalty defaults can equally influence, in a backward induction, the parties' incentives during the subgame of their contractual relationship (including the bidding process). If the parties know that they will be forced to divulge private information about their contractual behavior during an arbitral dispute,

[733] Id., at 820.
[734] Id., at 818-826, 847.

they will have fewer incentives to behave opportunistically during the implementation of their contract for fear of facing adverse inferences and penalties at a later arbitral proceeding.[735]

In other words, in an environment where the tribunal cannot observe the contested facts directly, but relies on proxies to establish the truth, it is essential to address the parties' potential appetite to exploit the arbitrators' bounded rationality and use the adversarial adjudicatory process in order to opportunistically serve their self-interest. Adverse inferences and penalty defaults are instruments that arbitrators can use to economize on these transaction costs by forcing the parties to divulge material information to the tribunal, thus limiting the risk of opportunistic behavior either during or prior to the arbitral proceedings.

c) *Penalty default rules and the incentive for information disclosure*

This section takes a *de lege ferenda* approach to the role that penalty default rules can play in the particular context of state contracts, and specifically in anticipation of a treaty dispute between the host state and the foreign investor. In reverse, it does not take a *de lege lata* position on whether and to which extent there actually are penalty default rules in contract law - a question forming part of the debate between *Ayres* and *Gertner*, on the affirmative side, and *Posner* on the negative side.

As a reminder of this debate, *Ayres* and *Gertner* have introduced the concept of the "penalty default rule", meaning a rule that fills a gap in an incomplete contract with a term that would "not" have been chosen by the majority of similarly situated parties. The purpose of such rule is to address the problem of information asymmetries by forcing the better informed party to reveal its private information to its counterparty, thus enabling the latter to perform more efficiently, than if it were uninformed.

The premise of penalty defaults are the different sources of contractual incompleteness. Whereas the majoritarian - "would have wanted" - default aims to minimize the

[735] The investor-state dispute settlement system can be considered as one of those nascent and evolving fields prone to the analysis of behavioral law and economics. As *Goldgeier* and *Tetlock* note, the potential explanatory role of psychological constructs expands rapidly as we move from domains where the design of institutions is guided by "well-known" facts and "solid science" to those where the expert community is deeply divided thus leaving ample opportunity for cognitive and emotional biases to taint evaluations of evidence and options. See Goldgeier, J.M. & Tetlock, P.E., (2001), *Psychology and International Relations Theory,* Annual Review of Political Science, 4: 67, at 79. See also van Aaken, A., (2013), *Behavioral International Law and Economics,* Harvard International Law Journal, 55: 421, at 438.
On the (still-to-be-identified) nature of international investment arbitration as "platypus", see Roberts, A. *supra* note 62.

transaction costs of contracting, the penalty default aims to cure a second source of contractual incompleteness, that of "strategic withholding of information", whereby one party attempts to increase her private "share of the pie" at the cost of the overall "size of the pie". In this context, the "strategic contractual behavior of the parties can justify a strategic interpretation" of the invoked provisions "by the court" (or arbitral tribunal).

Moreover, penalty defaults serve to create "separating equilibria", whereby the different types of contracting parties bear the costs of contracting around "unwanted" defaults, thus separating themselves into "distinct" contractual "relationships". This way the use of penalty default rules can help distinguish between foreign investors aiming to form a contractual relationship premised on adverse selection and moral hazard from those aiming to contract in good faith and renegotiate only where there is an actual need to do so, and not as a means for shifting rents to their benefit.

An example how a penalty default rule can restrict rent-seeking, is the case of *Hadley v. Baxendale*, where the court reversed a damages award for lost profits, holding instead that only foreseeable consequential damages should be awarded. *Ayres* and *Gertner* argue that *Hadley* operates as a penalty default rule, because it forces the informed party (here, the miller) to inform its counterparty (the carrier) about the potential consequential damages, and contract for full damage insurance. The default thus operates as a purposeful inducement to the informed party to reveal the relevant information to its counterparty, which (in the present case) is a more efficient risk bearer.[736]

An application by analogy of the *Hadley* rule in international investment arbitration could provide useful insights into ways of increasing predictability and fairness in awarding damages to the investor. The dominant actual method for calculating damages has been the "but-for" method for expected losses.[737]A penalty default rule that would force the investor to reveal information about the causal relationship between a renegotiation and the actual losses or profits that such renegotiation caused to its investment, would dissuade excessive and unproven damages requests. This question remains to be explored, though, at a later paper, as the issue of damages *per se* falls outside the scope of the present thesis.

In summary, *Ayres'* and *Gertner's* theory on penalty default rules rests on the premise of giving at least one of the contractual parties the "incentive" to contract around the default. Penalty defaults are thus efficient rules for encouraging the production of information, as the very process of "contracting around" can reveal information to parties, either internal or external to the contract. In particular, penalty defaults can play two roles: they can give the more informed party the incentive to disclose information to

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[736] See Ayres, I. & Gertner, R., *supra* note 551, at 94-102.
[737] See Wöss, H., San Román Rivera, A., Spiller, P. & Dellepiane, S., *supra* note 64.

its counterparty, or they can induce both contracting parties to reveal material information to a third party, the court[738] (or arbitral tribunal), which would otherwise be at a disadvantaged position to verify such information.

On the other side of the debate stands Professor *Posner*, who argues that there are no penalty default rules in contract law, and none of Ayres' and Gertner's examples are in fact such rules. In particular, he argues that neither the zero-quantity default in the UCC nor the *Hadley* rule qualify as penalty defaults. On the contrary, the first is an element of a legal formality, whereas the second is a majoritarian and not a penalty default rule.[739]

What is worth stressing, though, is that *Posner* does not contest the "normative" argument on the utility of penalty default rules for curtailing strategic behavior and rent-seeking by forcing the disclosure of private information to the contractual counterparty and the court. On the contrary, he recognizes that the concept of penalty defaults has been used also in other areas of the law, such as statutory interpretation, and behavioral economics, and argues that default rules are analytically the same as "interpretive" rules, as they both serve to resolve ambiguities in the disputed contract - the latter by means of interpretive presumptions, and the former by gap-filling.[740] "The similarity of the two instruments justifies perfectly the use of penalty defaults in the interpretation of investment treaties", and especially the FET standard.

Indeed, the aim of this thesis is to further the use of penalty default rules by applying them (by analogy from contract theory and behavioral economics) to international investment law, and investor-state dispute settlement in particular. The following sections elaborate on the normative argument for the use of penalty default rules in investment arbitration and the concrete ways in which such use can be operationalized, including through the use of adverse inferences for the production of evidence.

d) *Contract Analogies in International Investment Arbitration*

Treaty-based arbitration is a process relying heavily on the production of evidence, which, as aforementioned. is brought to the tribunal selectively by self-interested parties. In this high-risk environment of bounded rationality (including the difficulties of verifying the renegotiation conditions to the court) and opportunism characterizing the operation of concession contracts, penalty default rules can help achieve an alignment of

[738] See Ayres, I. & Gertner, R., *supra* note 551, at 97.
[739] Posner, E. (2006), *There are no Penalty Default Rules in Contract Law*, Florida State University Law Review, 33: 563, at 565, 568.
[740] On the application of behavioral economics in international law, see van Aaken, A. *supra* note 746.

the parties' incentives forcing them to act in good faith both during the adjudication of their disputes and (in a backward induction) the implementation of their contract.

More specifically, a penalty default rule would enable the host state to evaluate the true credibility of the investor's bid and its commitment to implement its investment obligations.[741] Forcing the investor into credible commitments would in turn prevent adverse selection (that is, the selection of a strategic overbid or underbid). It would also discourage moral hazard, as it would dissuade an investor from requesting strategic renegotiations, subsequently using treaty arbitration as a means to force the state's hand to accept its terms, otherwise face a claim for breach of the overarching treaty.

Such risk of opportunism can materialize in case the state refuses to accommodate the investor's renegotiation request, assuming back the concession instead, and the investor as a consequence takes recourse to arbitration claiming breach of the fair and equitable treatment obligation, or expropriation. In this case, the "strategic behavior" of one of the contractual parties, the investor, justifies the "strategic interpretation" of the treaty by the arbitral tribunal.[742]. Such strategic interpretation would force not only the state, but also the investor, to act in good faith in implementing its investment obligations, for fear of facing penalties, if it fails to do so, not only at the domestic but also at the international level.

A strategic interpretation in this context would mean that the tribunal shall use a penalty default rule that would preclude a treaty breach on the basis of the host state's refusal to accommodate the investor's renegotiation request, unless there was an agreement to the contrary and the investor presents evidence showing that the conditions of such agreement were fulfilled. The use of a penalty default would of course complement the interpretation of the treaty standards based on relational contract theory, and particularly the use of the UNIDROIT Principles on hardship as the applicable international legal standard for judging the legality of a contractual renegotiation.

Such penalty default rule - which could be incorporated either in the treaty itself or in the applicable rules of procedure – could take the following form: "Renegotiation is allowed only in case of a material change of circumstances amounting to hardship, unless otherwise agreed by the parties. The burden of proof on the materialization of the contingency justifying renegotiation falls on the party requesting such renegotiation."

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[741] On "credible commitments", see *supra* Williamson, O. (1983), *Credible Commitments: Using Hostages to Support Exchange*".
[742] See Ayres, I. & Gertner, R., *supra* note 551.

First, this provision bears the clear marker of a default rule, that is, the phrase "unless otherwise agreed".[743] Second, it aims to strike a balance between "front-end" and "back-end" costs, or in *van Aaken's* words, between commitment and flexibility. This trade-off is reflected in the need to adapt the contract to the changed circumstances, thus allowing for the necessary flexibility and efficient renegotiations increasing the parties' joint surplus. On the other hand, renegotiation is allowed only if the change is material, resulting from hardship. This caveat serves to restrict the parties' flexibility in favor of the credibility of their commitments, in order to filter out bad-faith renegotiations aiming at shifting rents from one party to another instead of maximizing the overall contractual efficiency.

In addition to addressing the trade-off between commitment and flexibility, the proposed provision also tackles the transaction costs of bounded rationality and opportunism. It does so by establishing a penalty default rule that encourages the production of information about the renegotiation of the contract, including its reasons, results, and process. Increasing the transparency of renegotiation, and in particular its verifiability to the court, is a prerequisite to attaching any legal consequences to its occurrence. Given the fact that typically renegotiations take place outside any contingencies stipulated in the contract itself, they have often been a disordered (if not under-the-table) process.[744] This has resulted in a lack of visibility of the parties' conduct, which has led arbitral tribunals to adopt a static and one-sided approach in interpreting the FET standard when deciding whether it was breached as a result of a contractual renegotiation.

The above penalty default rule attaches legal consequences to the choice of not "contracting around" the default. In particular, a party aiming to renegotiate for reasons other than a material change in circumstances (as the proposed default rule, justified by bounded rationality and hardship), namely in order to strategically shift rents to its benefit, would face the risk of an adverse decision by a later arbitral tribunal. The specific penalty that the tribunal would attach to the fact of not contracting around the default is the rejection of any treaty claim as a result of a contractual renegotiation falling outside the scope of the default rule. This would mean that, had such renegotiation taken place at the request of the investor, the latter would be *estopped* from invoking subsequently a breach of treaty on this basis.

Similarly, a state requesting renegotiation due to hardship would not be found liable for a consequent breach of treaty, unless the parties had contracted around the default by excluding hardship from the reasons justifying renegotiation – in which case not only the state but also the investor would be unable to request renegotiation on the basis of

[743] See Posner, E., *supra* note 750, at 4.
[744] With the exception of the *Biwater* case examined above, where the government assigned the process to an independent mediator.

hardship (let alone of severe financial difficulties in managing the concession). Such rule would reflect the relational character of both concession contracts and the overarching investment treaties, as it would offer both contracting parties equal arms to legally adapt their contract to changed circumstances.

Forcing (the better informed of) the parties to contract around the default would equally force them to reveal information about their actual renegotiation intentions.[745] The strict renegotiation conditions of the proposed default rule would also induce investors to perform their due-diligence duties, under the penalty of being bound by their commitment to the concession without being able to renegotiate, unless they prove hardship.

More specifically, the above rule performs both functions of information disclosure, by making material information both observable by the contractual counterparty and verifiable to the court. This means that the party requesting renegotiation for reasons other than hardship would have to present to its counterparty all the information justifying the necessity to renegotiate. At the same time, it would have to produce the relevant evidence justifying such (not stipulated in the contract) renegotiation to the arbitral tribunal judging an alleged treaty breach due to the failure of this renegotiation.

To summarize the function of the proposed penalty default rule, if the parties wish to widen the scope of legal renegotiations, they would have to contract around this default, including a more flexible renegotiation provision in their contract that strikes a trade-off between commitment and flexibility more customized to their individual needs. By stating their explicit intention to widen the scope of renegotiation, the parties are thus forced to disclose private and material information about both their true intent to implement the contract and their renegotiation strategies, as well as their overall efficiency in managing their relationship and the concession.

If, in reverse, the parties do not contract around the default rule, the penalty would be the prohibition to renegotiate for any other reasons except for the ones stipulated in the clause above. The purpose of the penalty default rule is to fill the gaps in the inherently incomplete concession contracts, thus addressing the bounded rationality, by penalizing at the same time the party behaving opportunistically. Consequently, forcing the party that intends to request a rent-shifting renegotiation (by exploiting the conditions of bilateral dependency, in which concession contracts by definition operate) to contract around the default, would simultaneously force it to disclose its true (renegotiation)

[745] On the focus on "intentions" as a factor influencing preferences, see van Aaken, *supra* note 746, at 434. According to the tenets of behavioral economics (as opposed to rational-choice theory), preferences are formed not only on the basis of material payoffs, but also, crucially, of intentions (meaning beliefs about the reasons for an agent's choice of a certain action).

intentions, thus alleviating information asymmetries between the parties. Moreover, giving the parties' incentives to reveal their intentions would increase contractual efficiency, when it is costlier for the tribunal to discover that information *ex post*, or in other words, when *ex ante* contracting is cheaper than *ex post* litigation.

As regards the legal effects of the renegotiation request, the rejection by the host state of the investor's renegotiation request or proposed new terms, would preclude a breach of FET, unless there is a provision stating otherwise, thus creating legitimate expectations to the investor to this effect. In other words, in case an investor brings a FET claim because the host state refused to accommodate its renegotiation request and decided instead to take back the concession - as happened in the *Biwater* case above - the tribunal shall find the state's conduct to be fair and equitable on this basis.

A penalty default rule would have been weak and incomplete without the concomitant possibility to use "adverse inferences" in the production of "evidence", which would (dis)prove the occurrence of a contingency justifying renegotiation. The following section elaborates on the role that adverse inferences can play for incentivizing the parties to disclose material information to the tribunal, which has wide "discovery" powers (akin to those of common-law courts).

e) The production of evidence and the use of adverse inferences

The penalty default rule designed above aims, as explained, to incentivize the parties to engage only in good-faith, efficiency-improving renegotiations, under the penalty of otherwise having their claims (or defenses) rejected in a subsequent arbitral proceeding. However, in order for contractual renegotiations to produce legal effects, they have to be visible, and in particular evidenced and verifiable to the tribunal. Moreover, given the common information asymmetries characterizing the relationship of the parties to a concession contract and the self-interested presentation of evidence to the tribunal, rent-seeking renegotiations can only be prevented, if the parties know that withholding the relevant information would entail penalties at an arbitration proceeding, both in the form of adverse inferences and as a consequence of an adverse treaty interpretation.

In other words, adverse inferences are the "cousin" of penalty default rules in the specific field of the production of evidence, because they play a similar, fundamental role in forcing the disclosure of private information, particularly to the court. Consequently, they complement the objective of penalty defaults to deter perverse incentives and rent-seeking by means of information disclosure, and the consequent alleviation of information asymmetries and the transaction costs of non-observability and non-

verifiability. The rationale behind adverse inferences is the fact that *ex ante* contracting can be cheaper than *ex post* litigation.[746]

The issue of the production of evidence is central in all investor-state arbitral proceedings and has figured prominently, *inter alia*, in the Argentine cases, where Claimants (for example, *Sempra* and *Azurix*) persistently refused to produce documents requested by the Respondent to prove the reasons for and conditions of renegotiation. Had such renegotiations been evidenced from the outset (for example, with the mediation mechanism proposed above), and had the tribunal drawn negative inferences from the parties' refusal to produce documents, the parties would have obviously had a stronger incentive to reveal their private information, otherwise face the penalty of having their arguments rejected by the tribunal.

Unlike the mechanism of penalty default rules, which is a novel, prescriptive proposal advanced herein, adverse inferences are already stipulated by law and have already been in arbitral practice. In particular, the IBA Rules on the Taking of Evidence in International Arbitration read in Article 9 (5) that "if a party fails without satisfactory explanation to produce any Document requested in a Request to Produce to which it has not objected in due time or fails to produce any Document ordered to be produced by the Arbitral Tribunal, the Arbitral Tribunal may infer that such document would be adverse to the interests of that party". In a similar vein, Article 9 (6) provides that "if a party fails without satisfactory explanation to make available any other relevant evidence […] sought by one party to which the Party to whom the request was addressed has not objected in due time or fails to make available any evidence […] ordered by the Arbitral Tribunal to be produced, the Arbitral Tribunal may infer that such evidence would be adverse to the interests of that Party." [747]

Greenberg and *Lautenschlager* distinguish between "improper" and "proper" adverse inferences. The former only influence the weight attached to existing evidence [748] (without this diminishing their importance as essential tools for assessing evidence, and the most widely used adverse inferences). On the other hand, "proper" adverse inferences are genuine "gap fillers" substituting for an essential piece of evidence without which the claimant (of the argument substantiated by the missing piece of evidence) would risk losing its case based on its own evidence alone.

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[746] See Ayres, I. & Gertner, R., *supra* note 551, at 97.

[747] See the IBA Rules on the Taking of Evidence in International Arbitration, Adopted by a resolution of the IBA Council 29 May 2010, International Bar Association.

[748] van Houtte, V. (2009), *Adverse Inferences in International Arbitration*, in (Eds.) Giovannini, T. & Mourre, A., *Written Evidence and Discovery in International Arbitration: New Issues and Tendencies*, Dossiers, ICC Institute of World Business Law, at 196

If the party called upon to produce the missing evidence refuses to do so, the arbitral tribunal can assume the unproven fact to be true, unless that party proves otherwise. This judicial strategy effectively "shifts the burden of proof" for this specific fact, and can constitute an essential element for the counterparty to win its case.[749] Adverse inferences thus play a role similar to "sanctions" thus being complementary to the punitive effects that penalty default rules produce.[750]

Apart from the IBA Rules, the jurisprudence of the *Iran-US Claims Tribunal* has also produced useful insights into the use of adverse inferences in international law. *Sharpe* has distilled the relevant case law and formulated a five-prong test for drawing adverse inferences, composed of the following prerequisites: First, the party requesting the missing evidence must produce all the relevant evidence corroborating the inference sought. Moreover, the requested evidence must be available to its opponent. Third, the inference sought must be reasonable, consistent with facts in the record and logically related to the probability of the evidence withheld. Fourth, the party seeking the adverse inference must produce *prima facie* evidence, and last, the inference opponent must know or have reasons to know of its obligation to produce evidence rebutting the adverse inference sought.[751]

This test has been confirmed by the ICC practice. Empirical analysis shows that adverse inferences have been drawn in one third of the examined awards, with seven of those instances having been decisive for the outcome of the cases. In all twelve cases (of the thirty-six cases examined) the adverse inferences were based on a party's non-production of documents following a document production order.

Regarding the reasons for seeking an adverse inference, the most common one has been the non-production of documents (more than half of the cases). This reason covers both the cases where the one side had a general suspicion that its counterparty had omitted to produce evidence, and those cases where the counterparty openly refused to produce certain documents (claiming, for example, that they had been destroyed or were confidential). In eleven of the nineteen instances the tribunal concluded that the non-

[749] Greenberg, S. & Lautenschlager, F. (2011), *Adverse Inferences in International Arbitral Practice,* at 45-47

[750] The terminological debate whether adverse inferences are "sanctions" – as van Houtte seems to suggest – or indirect pieces of evidence, as Greenberg and Lautenschlager contend – does not overshadow their actual punitive function against the party that refuses to produce material evidence to the tribunal thus preventing its counterparty from fully supporting its case.

[751] Sharpe, K. (2006), *Drawing Adverse Inferences from Non-Production of Evidence*, Arbitration International, 22 (4): 549, at 550.

produced documents would have been adverse to the interests of the non-compliant party.[752]

Two cases have laid down the principles for drawing adverse inferences in international arbitration. In the first one, the *Marvin Feldman v. Mexico* case, the arbitrator highlighted that, although the general rule in international arbitration is that the party asserting a fact is responsible for providing proof thereof, "such burden may shift to the responding party to rebut that evidence, when the party carrying the burden of proof furnishes evidence sufficient to raise a presumption that what is claimed is true." [753]

In the second arbitral case, seated in Paris in 2004, the Terms of Reference explicitly provided that, if a party fails without satisfactory explanation to produce any document requested by the other party and subsequently ordered to be produced by the tribunal, the tribunal has the power to infer that such document would be adverse to the interests of that party. The tribunal concluded that, "where it has reason to believe that such document exists, and no valid excuse for its non-production is offered", the tribunal may draw an adverse inference with regard to a specific fact (meaning that for all other matters the burden of proof rests with the party bringing the relevant claims).[754]

Adverse inferences have also been confirmed by ICSID practice. The authority of an ICSID tribunal to draw an adverse inference is sanctioned in Article 34 (4) of the ICSID Arbitration Rules prescribing the duty of the parties to cooperate with the tribunal in the production of evidence, and instructing the tribunal to "take formal note of the failure of a party to comply with its obligations and of any reasons given for such failure." Regarding the modalities of making adverse inferences, in some instances an initial procedural order expressly authorizes the tribunal to draw such inferences,[755] whereas in others the order refers to the aforementioned provisions of the IBA Rules on the Taking of Evidence in International Arbitration.[756]

Among the recent ICSID cases where the tribunal took recourse to adverse inferences, is the *Metal-Tech v. Uzbekistan* dispute. To enable the respondent to corroborate its corruption defense, the tribunal ordered the investor to produce documents proving that the contested consulting services were in fact legitimate. The Claimant refused to produce the requested evidence, which led the tribunal to infer that the investor could

[752] See *supra* Greenberg, S. & Lautenschlager, F., at 49.
[753] *Marvin Feldman v. Mexico*, ICSID Case No. ARB(AF)/99/1, Award, 16 December 2002, para 662.
[754] See *supra* Greenberg, S. & Lautenschlager, F., at 51-52.
[755] For example, in *ISTROKAPITAL SE v. Hellenic Republic*, the procedural order specified that the failure to produce documents as ordered may result in adverse inferences drawn by the tribunal as regards the credibility of a witness or the merits of the defaulting party's case. See Polkinghorne, M. & Rosenberg, C. (2015), *The Adverse Inference in ICSID Practice*, ICSID Review, 30: 741, at 744.
[756] See ICSID Rules of Procedure for Arbitration Proceedings (Arbitration Rules), Retrieved from: http://icsidfiles.worldbank.org/icsid/icsid/StaticFiles/basicdoc/partF.htm

offer no evidence that legitimate services had been provided, and conclude that it lacked jurisdiction due to corruption in violation of the host state's domestic law.[757]

Last, domestic courts have also taken the practice of drawing adverse inferences seriously. For example, the Singapore High Court in the *Dogwoo Mann* case confirmed that an arbitral tribunal should provide a thorough reasoning on the possibility of making an adverse inference as a consequence of a party's failure to comply with a document production order.[758] Similarly, the Paris Court of Appeal recently approved the drawing of inferences by tribunals in compliance with the IBA Rules on the Taking of Evidence in International Arbitration, refusing to set aside an ICC award based on such inferences.[759]

It ensues from the above that adverse inferences are valuable tools for forcing the parties to cooperate with each other - thus making private information observable to the counterparty - and the arbitrators, thus making information verifiable to the tribunal. In addition to increasing the observability and verifiability of material evidence, adverse inferences also contribute to the administration of justice by enabling a party to satisfy its burden of proof, when evidence is withheld by its counterparty. Consequently, as long as adverse inferences are justified by proper reasoning to avoid a challenge of the award due to the preclusion of a party from presenting its case, they can serve as necessary complements to the use of penalty default rules proposed above.

In particular, the utility of adverse inferences in the specific context of treaty disputes arising from the renegotiation of concession contracts is evident. Increasing the verifiability of material evidence to the tribunal is a prerequisite to applying any penalty default rule for the disclosure of private information. Adverse inferences thus complement penalty defaults by forcing the party requesting renegotiation not only to disclose the reasons for its request and all the relevant information to its counterparty, but also to place the relevant evidence at the disposal of the tribunal under the penalty of otherwise having the tribunal consider the evidence to benefit its counterparty.

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[757] *Metal-Tech Ltd v. Republic of Uzbekistan*, ICSID Case No. ARB/10/13, Award, 4 October 2013, paras 372-373. Other ICSID cases where the tribunals drew adverse inferences were *Europe Cement v. Turkey* (*Europe Cement Investment & Trade S.A. v. Republic of Turkey*, ICSID Case No. ARB(AF)/07/2, Award, 13 August 2009), *Rompetrol Group v. Romania* (The Rompetrol Group N.V. v. Romania, ICSID Case No. ARB/06/3, Award, 6 May 2013), *OPIC Karimun v. Venezuela* (OPIC Karinum Corporation v. The Bolivarian Republic of Venezuela, ICSID Case No. ARB/10/14, Award, 28 May 2013), and *Gemplus v. Mexico* (Gemplus S.A., SLP S.A., Gemplus Industrial S.A. de C.V. v. The United Mexican States, ICSID Case No. ARB(AF)/04/3, Award, 16 June 2010). See Polkinghorne, M. & Rosenberg, C., *supra* note , at 747-750.

[758] See *supra* Greenberg, S. & Lautenschlager, F., at 55.

[759] Use of adverse inferences approved by Paris appeal court, http://globalarbitrationreview.com/article/1137955/use-of-adverse-inferences-approved-by-paris-appeal-court

Another case exemplifying the difficulties in obtaining evidence relating to the renegotiation of a concession contract was the dispute of *Azurix v. Argentina*. The Claimant objected to the respondent's evidence request, whereas on the contrary, the Respondent demonstrated its willingness to produce the evidence that *Azurix* requested from the Province. Indeed, Argentina furnished the documentation requested by the tribunal's procedural order, and pointed out changes in the concession contract that were not part of the draft agreement included in the bidding documents.

Consequently, the tribunal issued another order, whereby it requested *Azurix* to furnish its own copies of the bidding documents. However, *Azurix* refused to do so and instead of presenting its own copies of the evidence requested, it sought copies directly from the Province, allegedly for convenience's sake. It is evident that the investor would have been incentivized to produce the requested documents, had it been faced with the penalty of adverse inferences due to its refusal to cooperate in the production of evidence.

3. The Politics of Treaty Interpretation

The legal-realist taken above (and in the entire thesis) would be incomplete without reference to the political side of treaty interpretation and the politics of international investment arbitrators. As aforementioned, rules or no rules, method or no method (and the mechanic reliance on them, or not), in the final analysis interpretation is a human activity depending on the efforts of human beings, their sensibilities, and their sense of virtue. In other words, arbitrators themselves are also human beings engaged in their own politics and having their own incentives while interpreting and applying the vague standards of investment treaties, especially the standard of fair and equitable treatment.

Pauwelyn has taken a legal-realist view in identifying politics as a factor determining the choice of interpretative methods and their outcomes. Highlighting the distance between the normative interpretative theories in international law[760] and the pragmatic international relations literature, he notes the absence of empirical work on the observed variance of behavior across international tribunals. *Pauwelyn* thus engages in an interdisciplinary enterprise to fill this gap by providing a conceptual toolkit inspired by both international law and international relations theories to approach the various interpretative choices and their underlying explanations.

Having identified five broad types of interpretative choices, categorized along the spectra of dominant hermeneutic (text, intent, or object); timing (original vs. evolutionary);

[760] Much like the common law approach has done in highlighting the prescriptive, but not necessarily realistic assumptions and proposals of the different ideological schools of treaty interpretation.

activism (rule agents vs. gap fillers); precedent (case-by-case vs. precedent), and linkage (self-contained vs. systemic), *Pauwelyn* aims to pinpoint the essential drivers behind the tribunals' choice of one interpretative method over the other. He finds this interpretative choice to be the result of the interaction of two key variables: the demand side *interpretation space* and the supply side *interpretation incentives*.

In turn, interpretation space is defined by the degree of *contractual incompleteness of the treaty* and the principals' ability for collective action.[761] These issues were touched upon above when explaining that investment treaties are inherently incomplete, relational contracts that contain standards and not precise rules, and the establishment of mechanisms of ex post intervention by states (especially through administrative commissions) can perhaps control the tribunal's interpretative space (or authority) but will certainly not make it redundant.

Within the defined interpretation space tribunals have the discretion to decide the interpretative method they will deploy. The choice they will make depends on their incentives, which are, in turn, influenced by institutional factors and dominating norms. In the first category belong especially the tribunal's lifespan, the composition of the constituency affected by the award, and institutional competition (or lack thereof). Competition can come not only from other specialized tribunals, but also from courts having in principle a different mandate. For example, investment tribunals can be put under pressure and scrutiny for their interpretative practices following the decision on a landmark case that the ICJ is currently set to decide, namely the claim that Iran lodged against the US regarding the US Executive Order allowing enforcement by US claimants against Iranian assets to collect damages from terrorist attacks. A central claim raised in this regard is that the US denied Iranian entities fair and equitable treatment.

As a result, the interpretation by the ICJ of the standard can put competitive pressure on future investment tribunals, when called to decide on the same standard – in a similar way that ICJ decisions have proved influential for investment tribunals even before the surge of investment disputes, as happened with the *ELSI* and *Barcelona Traction* cases. It is to be noted that this is one of the first, unique opportunities for the ICJ to deal directly with an investment dispute, and offer an interpretation of the FET standard.

Much like in case of lack of long-term cooperation between a foreign investor and a host state,[762] tribunals not forming part of an institution of long-term cooperation with their

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[761] See Pauwelyn, J. & Elsig, M. *supra* note 451.

[762] Which is the case when a foreign investor takes a position in an investment in the host state simply as an occasional part of its global investment portfolio, as opposed to diversifying its investment in the local economy – on this definition of "relational" contracts and their importance for the long-term cooperation of the parties, see Post, A., *supra* note 103.

principals have fewer incentives to develop systemic and precedent-based interpretations. It is remarkable that despite the lack of such institutionalized long-term cooperation, and the *ad hoc* nature of investment arbitral tribunals, arbitrators have gone a long way (from the first wave of cases that adopted the investor's rights approach) in developing (even inconsistently) a systemic interpretation of treaty standards making use of precedent.

This trend of systemic, evolutionary, and precedent-based interpretation cannot but attest to the fact that investment arbitrators have in fact established a long-term cooperation with their principals, except that - due to the relational nature of investment treaties involving a wider network of stakeholders than (strictly speaking) the contracting states - principals are defined herein widely to include also the foreign investors having standing before an arbitral tribunal.

The fact that the investor-state dispute settlement has de facto developed some sort of precedent, despite the lack of an institutionalized long-term cooperation and the *ad hoc* nature of arbitral tribunals illustrates the argument made herein about the relational character of investment treaties that engage more stakeholders than the (strictly speaking) contracting states. The fact that investment arbitral tribunals have gone a long way (from the first wave of cases that adopted more the investor's rights approach) in developing (albeit often inconsistently) a *systemic* interpretation of treaty standards making use of *precedent*, cannot but attest to their recognition of investors as prominent stakeholders - if not quasi-principals - in investment treaties.

Norms and principles also influence the arbitrators' interpretation incentives. Legitimacy is (or should be) of particular concern, especially for younger tribunals that have not yet established a reputation as a legitimate platform for resolving disputes, even less so when those disputes involve sensitive policy issues. The prediction is that tribunals that are young and face "bias" concerns may act more timidly than well-established tribunals, such as the WTO's Appellate Body (which in its early phases, though, was cautious enough to clearly indicate its interpretative steps in order to fend off potential criticism for lack of coherence).[763]

Nevertheless, this has not been the case with the investor-state dispute settlement system, where, despite its infancy, tribunals have showed significant activism in interpreting the treaty standards – especially FET – and balancing conflicting policy interests. Such activism can be explained, though, by the other elements determining the politics of treaty interpretation, namely the aforementioned *ad hoc* nature of these tribunals and the constituency which they want to please the most, as well as the existence of an interpretative community that develops shared concepts within an epistemic community.

[763] Weiler, J. (2001), *The Rule of Lawyers and the Ethos of Diplomats*, Journal of World Trade, 35 (2): 207.

The more concepts shared within a field (such as the concept of "legitimate expectations"), the more entrepreneurial the tribunal may act. In such scenario, the interpretative preference usually is for *gap-filling*, *evolutionary* interpretation, and the development of *precedent*.

The analysis would of course be incomplete without taking into account the legal tradition that interpreters come from. Tribunal members of the civil law tradition are more likely to engage in gap-filling, evolutionary interpretation and the development of precedent, in an effort to build a coherent legal system, as opposed to common-law judges that are usually expected to focus on the designers' intentions and adopt a textualist approach. In the specific context of investment arbitration, the two main interpretative schools are those of commercial lawyers focusing on just resolving the dispute before them, and lawyers with a public-international law background, who tend to opt for a more textual and systemic interpretation recognizing a role for precedent in interpreting investment treaties.[764]

[764] See Pauwelyn, J. & Elsig, M. *supra* note 451. See also Laird, I. (2008), Interpretation in Investment Arbitration – Through the Looking Glass, Retrieved from: https://www.ogel.org/article.asp?key=3230

The question on the proper method for interpreting international investment treaties has preoccupied the epistemic community of international scholars (coming from different backgrounds) for quite a long time. The present thesis addressed this thorny matter by departing from the various ideological camps and their ensuing policy prescriptions for reforming the investor-state dispute settlement, and taking instead a legal-realist, bottom-up approach to investment-treaty interpretation. It did so by constructing a "two-prong argument" based, on the one hand, on the connection between the treaty and the state contracts signed under its auspices and using, on the other, the renegotiation of such contracts as a natural experiment showing the relational character of such contracts.

It is this combination of the "relational" nature of the underlying "contracts", and the inseparable "connection" between them and the overarching "treaty" that makes "relational contract theory" the appropriate interpretative method for imparting meaning to the standards contained in investment treaties, and particularly the (most contentious) standard of fair and equitable treatment. The receptivity of those standards to the interpretative method of relational contract theory is reinforced by their own very nature as relational standards. Their relationality is owed to their vague and open-textured formulation, which makes them "inherently incomplete" and dependent on the individual circumstances of the way that the particular contractual relationship between the state and the investor has been implemented and evolved.

Proposing contract theory as the proper interpretative method for investment treaties is an emerging trend, but not an entirely new venture. Already in early 1930s, *Lauterpacht* uncovered the blurred distinction between public and private laws. Taking issue with the positivist school and adopting a legal-realist approach, instead, drawn from international relations and the actual practice of states, *Lauterpacht* applied private-law analogies to international law, thus setting the path for the application of contract theory to treaty interpretation, especially by arbitral tribunals.

Following *Lauterpacht's* and other legal-realists' footsteps, several scholars have pointed in the last few years, to the contractual nature of international investment treaties. They have similarly translated several dilemmas of contractual origin - especially the trade-off between commitment and flexibility (or *pacta sunt servanda* vs. *clausula rebus sic standibus*) - into international principles for treaty interpretation. Such contractual principles often focus on the design of incentive structures forcing the parties to "cooperate in a game of repeated interactions" when implementing the treaty. A telling example of the use of contractual principles for treaty interpretation has been the

application in investor-state dispute settlement of the UNIDROIT Principles of International Commercial Contracts in order to interpret the vague treaty standards.

What makes the current project even more original than the mere application of contract theory to treaty interpretation is that it takes the debate on the connection between the two instruments even further. It does so by proposing a specific branch of contract theory, namely relational contract theory, as the proper interpretative method for investment treaties, by relying on the practice of contractual renegotiations as a natural experiment proving the inseparable connection between the disputed treaty and the underlying contract, the renegotiation of which gave rise to the treaty dispute.

The methodology for approaching the contract-treaty connection in this context resembles one of a three-level game: first, the research focused on the micro-cosmos of the underlying investment contracts by identifying, both doctrinally and empirically, those characteristics that make them relational. Second, the connection between those relational contracts and the standards (specifically FET) included in the overarching investment treaties was examined, and particularly the way that the contract's evolution and renegotiation affects the interpretation of such treaty standards. Last, through both a doctrinal and a case-law analysis, the focus moved specifically to those treaty standards (namely FET) bearing characteristics that make them akin to relational contracts, thus calling for the application of the principles of relational contract theory for their interpretation.

It is important to emphasize the dynamic nature of the current project. In a similar way that investment-treaty interpretation is a "hybrid" project on the making, relational contract theory is also a relatively nascent field, not solidified yet in a concrete and immutable body of law. It thus resembles to some extent the *lex mercatoria* and serves the needs of the common-law interpretative fiat often exercised by investment tribunals and gradually leading to a *de facto* precedent (which is subsequently formalized even by the very critics of such precedent, when they formulate more complete treaty standards, as is the case of the incorporation of "legitimate expectations" in the FET standard in the CETA).

The evolutionary nature of relational contract theory can often make it challenging to grasp it fully and translate it into practical terms and concrete policy prescriptions. Nevertheless, this thesis operationalized the theory by proposing two specific "interpretative proxies" based on its tenets: "dynamism" and "mutuality". The first proxy accounts both for the evolving nature of the parties' contractual relationship and the open-textured and open-ended character of investment-treaty standards calling for their equally dynamic interpretation. The second proxy acts as a gateway for inserting investor obligations into the international investment regime by means of a treaty interpretation

that takes into account the realities of the underlying contract, especially when it is the very renegotiation of such contract that gave rise to the treaty dispute.

One of the implications of using an evolving theory for interpreting equally mutable treaty standards is the importance of taking a holistic and open approach to all possible tools that such interpretative theory encompasses. Instead of adopting a (rather simplistic) one-sided legal response to multi-faceted problems (such as the principle of proportionality as a means to addressing all conflicting interests between the investor and the host state), the relational contract theory methodology proposes instead a "governance design" for the interpretation of investment treaties, aiming to serve a concrete policy purpose.

This purpose is the "economization of the transaction costs of bounded rationality and opportunism", and the ensuing "alignment of the incentives" of the contracting (and later, disputing) parties, in order to "force them to cooperate" while implementing their contract in the shadow of investment treaties (and the investor-state dispute settlement system incorporated therein). Drawing from relational contract theory and its emphasis on a wider set of stakeholders involved in the contractual relationship, the proposed governance design views foreign investors (in particular multinational corporations with complex transnational corporate-governance structures) as non-traditional, yet powerful international actors. Despite the official lack of regulation of these actors under international law, the relational approach has the potential of inserting investor obligations into investment treaties through the proper interpretation of the (inherently incomplete) standards included therein, thus making the system more balanced and, consequently, more sustainable.

Following the legal realism tradition, the current project does not build an interpretative theory encompassing all sorts of different disputes arising under an investment treaty. On the contrary, adopting a differentiation methodology - in line with the transaction-cost-economics analytical framework adopted herein - it takes the view that there is not a one-size-fits-all interpretative approach to all treaty disputes, which often bear distinctly diverse characteristics. What is needed instead, is a pragmatic interpretative methodology that matches (to quote *Williamson*) different transactions with different governance structures in a discriminating way. In this discriminating context, the emphasis herein has been on that particular category of "regulatory disputes" ensuing from the "renegotiation of state contracts" in the sector of energy infrastructure.

This project has both doctrinal and empirical implications of a wide scale. For the first part, it sows the seeds of a theory for the renegotiation of regulatory contracts signed and implemented in the shadow of international investment treaties. To this end, it has taken an innovative view on the (always highly contested) relationship between the two

instruments: instead of the common argument for the impact that investment treaties have had on the (internationalization) of the underlying contracts, it has looked also at the other side of the coin, that is, the impact that those contracts have, in their turn, on the overarching treaties.

The main argument made in this context is that relational contract theory shows that the terms of such contracts, as they evolve, act as "gap fillers" for the "default", vague "standards" included in investment treaties. Given the inherent incompleteness of such standards (especially the standard on fair and equitable treatment), the connection between the treaty and the contract, the renegotiation of which gave rise to the dispute, can help guide the interpretation of the contested treaty standards, in a way that strikes a better balance between public and private interests compared to alternative methodologies.

In economics terms, the deployment of such a novel interpretative approach for investment treaties, when judging disputes that involve the renegotiation of regulatory contracts, has evident implications for the alignment of the incentives of the contracting parties, who are forced to genuinely cooperate for the long-term success of the concession, under the penalty of having any opportunistic treaty claims rejected by the arbitral tribunal. In legal terms, the application of the proxies and tools of relational contract theory for interpretative purposes has clear effects on the "legal standard applicable" for judging "whether a contractual renegotiation was treaty-compliant" or not.

The inconsistency of arbitral decisions in this regard has revealed the lack of a coherent approach to an elementary dilemma that international investment law is called to address: the trade-off between stability and predictability, or between the principle of *pacta sunt servanda*, on the one hand, and the doctrine of *clausula rebus sic stantibus*, on the other. This thesis demonstrated the stark inconsistencies in the tribunals' legal reasoning regarding the "legal effects of a contractual renegotiation" on the alleged breach of a treaty standard. Their approaches have ranged from a requirement for absolute stability of the host state's legal system and the ensuing illegality of renegotiation as such, to a more relational perspective that deems renegotiation legally justifiable under certain circumstances (for example, hardship), and it is the "process" in which the renegotiation is conducted that makes a legal difference under the treaty.

Last but not least, it is important to underline the timeliness of the doctrinal and legal-realist endeavors that this research project engaged in. Its emphasis on contracts in the most sensitive sector of energy infrastructure could not have been more topical, as regulatory disputes in this domain are bound to rise. Among others, as a report produced by the IEA this July (2017) shows that, with rampant electricity demand growth and well

over 90% of electricity sector investments funded with regulated pricing or contracts to manage revenue risks, government policies and new business models will play a preeminent role in attracting more financing. It is evident that all these government energy policies and business models are naturally expected to give rise to more arbitral disputes, thus calling for interpretative methods that achieve a better balance between public and private interests, in a way that makes the investor-state dispute settlement system more consistent and sustainable.

Appendix: Categorization of ISDS Cases along the Contract-Theory Interpretative Spectrum

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
EDF	Illegal corporate governance practices Contractual renegotiation agreement with stakeholder engagement Overbidding Disproportionate debt-equity ratio Investor's non-compliance with due diligence obligations	Classical contract law methodology: textualist and static: emphasis on state's specific commitments without accounting for adaptation due to changed circumstances Investor's right approach: one-sided, no mutuality. Investor's conduct only relevant for contractual claims under domestic law (artificial contract-treaty disconnection). Contours of FET dependent on factual context. Element of comparative public law approach: need to balance investor's expectations with public interest (but no criteria for such balancing exercise)	Recognition of the importance of the process per se: adoption of proxy of dynamism (had the process succeeded timeously to produce results, there would have been no treaty breach). But no definition of criteria explaining the causal relationship between renegotiation and treaty breach	Breach of FET as a result of the contractual renegotiation. No establishment of criteria differentiating a treaty-abiding renegotiation from a treaty-breaching renegotiation
Enron	Diverging views of the disputing parties on the relevance of the renegotiation process per se for judging FET.	Partial departure from rigid textualist, classical-contract-theory, and the investor's rights approach: recognition of the necessity of	Recognition of the legal relevance of the renegotiation process itself, but only superficial: parties have to genuinely agree on	Breach of FET as a result of a protracted and disorderly renegotiation process per se

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	Argentina: process gradually advancing and many contracts already renegotiated v. Enron: process politically motivated and fruitless	renegotiation due to changed circumstances. Negotiated modification treaty-compliant but neoclassical contract law approach: adjustment mechanisms incorporated in the contract sufficed to achieve the necessary adaptation. Evolutionary interpretation of FET as a vague standard (interpretative proxy of dynamism), which has produced "general principles of law". Nevertheless, static and one-sided approach to its content: legal stability as an emerging element of FET (contradictory legal reasoning, as the tribunal also recognized the necessity of adaptation to changed circumstances). No explanation how to balance legal stability with adaptation in a treaty-compliant way	the outcome, but tribunal does not examine any aspects of the process. No establishment of clear criteria differentiating an illegal (act jure imperii) from a legal (act jure gestionis) renegotiation, but emphasis on the circumstances of the process (doubt, ambiguity, politicization, delays)	("guarantees dismantled […], where there was certainty and stability, doubt and ambiguity are the order of the day […], the long-term business outlook has been transformed into a day-to-day discussion about what comes next. Tariffs have been frozen for almost five years. The recomposition of the tariff regime is subject to a protracted renegotiation process imposed on the public utilities that has failed to provide a final and definitive framework for the operation of business in the energy sector". Emphasis added). It can be

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
				assumed that the finding could have been different, had there been due process instead
LG&E	Divergent views of the parties on the legal standard for interpreting FET. Claimants: legal stability and predictability, and the investor's basic expectations are basic components of the standard. Its relation with the minimum standard of treatment under customary international law is irrelevant, because this minimum standard has evolved since Mondev to include the investor's reasonable expectations. Respondent: the Claimants' interpretation of FET is so vague as to ignore the parties' obligations and rights. FET should be	Textualist, classical-contract-theory, VCLT approach, but also recognition of the generic nature of FET, the content of which "varies with the course of time and with the circumstances of each case" and makes it "difficult to establish an unequivocal and static concept" (proxy of dynamism). Nevertheless, static approach to interpreting "legitimate expectations" as part of FET, by considering as relevant those expectations created at the time that the investment was made.	Minimalist approach to the legal consequences of the renegotiation process per se. Only a passing reference to the process, which was considered imposed upon the claimants rather than a real renegotiation	Breach of FET as a result of both the contractual renegotiation as such and the process, i.e. the way that renegotiation was conducted (including the differentiated treatment of contracts in different sectors of the economy)

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	equaled to the minimum customary international standard of treatment			
CMS	Radically different views of the parties on the law applicable to the dispute. Claimant: only the treaty and international law apply, while the domestic law of the host state "plays only a marginal role, relevant only as a matter of fact". Respondent: Argentina's domestic legislation is applicable, particularly since the investor is subject to domestic law and the License is specifically governed by Argentine law	Static, textualist, classical-contract-theory interpretation with elements of the neoclassical contract theory approach, namely the consideration of the adjustment mechanisms incorporated in the contact (as opposed to general principles of law, which the tribunal deemed irrelevant for determining how the contract could be adapted to the crisis situation)	Consideration of the legal aspects of renegotiation (including "imprévision" as a valid reason for renegotiation) already at the phase of determining whether renegotiation constituted a breach of the treaty in the first place (instead of only considering it when examining the defenses, e.g. of necessity). However, inconsistent reasoning in that, despite recognizing the close interaction between the contract and the treaty and finding that renegotiation and adaptation of contractual obligations had occurred, the essence of international obligations remained nonetheless intact. Regarding the process itself, the approach was minimalistic, without establishing any causal	Breach of FET as a result of the renegotiation. The tribunal went as far in adopting a static, textualist, classical-contract theory approach to interpreting FET that it considered the Preamble's recital on the stability and predictability of the host state's investment framework ("founded" in this case "on solemn legal and contractual commitments") as part of the minimum standard of protection under customary international law

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
			relationship between the way renegotiation was conducted and the breach of FET	
Sempra	Renegotiation agreement reached between the Licensee and the host state, which was contested, though, by Sempra, as one of the shareholders to the concessionaire company. Parallel existence of a shareholder agreement, for breach of which the Claimant had initiated legal proceedings against the Licensee in the domestic courts of the host state. The case thus exemplifies the complex transnational corporate-governance arrangements under which a concessionaire company often operates, and the separate standing of individual shareholders under the BIT, who can bring shareholder claims for reflective	Contradictory disconnection between domestic and international laws: selective application of domestic corporate law only to support the investor's rights approach, as, despite holding that corporate arrangements fall under the jurisdiction of the national courts, the tribunal applied Argentine corporate law to shield the Claimant from the renegotiation agreement achieved between the Licensee and the host state regarding its claims under the treaty. However, it connected the contract and the treaty by holding that FET is linked with the principle of good faith under both contracts and treaties. Narrow, one-sided approach to "legitimate expectations" as part of FET: only (limited) option for host	Tribunal refused to pass judgment on the features of the renegotiation between the Licensees and the government, least between the shareholders. It considered the renegotiation agreements between the contracting parties as "res inter alios acta" towards the shareholder claimant, whose rights thus remained intact under the treaty (despite the renegotiation of the contract under domestic law). Nevertheless, pioneering approach in recognizing that a lawful renegotiation can either result from the parties' agreement or requested by a judge	Renegotiation itself as a legal consequence of "imprévision" (which the tribunal recognized as a general principle of law) is legal as long as it is consensual. On the contrary, the way it was implemented herein was by means of unilateral adjustment of the contract by the government. Consequently, it was the implementation of the renegotiation process itself that amounted to breach of FET

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	loss (which can impede a renegotiation settlement between the concessionaire and the host state)	state to argue for the frustration of its own legitimate expectations is by bringing a counterclaim		
Siemens	The Claimant itself distinguished between two types of renegotiation, the first one based on the Contract Restatement Proposal, and the second one imposed by the Emergency Law	Akin to the common-law approach emphasizing the importance of "law as process". Also, the tribunal moved closer to the relational contract approach by recognizing the inadequacy of the (neoclassical-contract-law) adjustment mechanisms incorporated in the contract and the ensuing need for its renegotiation. Nevertheless, it rejected the relational proxy of mutuality, as it did not take into account Argentina's argument that FET is based on good faith applying equally to investors and states, nor its claim that Siemens breached the standard during the failed renegotiations, inter alia, by systematically withholding information on its cost structure	The tribunal accepted the differentiation between the two types of renegotiation, and found only the second one to be based on the use of "superior governmental power", and thus forced and in breach of FET. Nevertheless, it rejected the Respondent's argument that the investor was estopped from bringing a claim regarding the renegotiation of the contract, as it had subjected itself to the process, and held that neither party may hold against each other positions that they may have taken during a good-faith renegotiation	Breach of FET as a result of the forced renegotiation process based on the Emergency Law, and the repudiation of the previously renegotiated terms by the new government, which refused to validate the agreement of its predecessor and terminated unilaterally the contract, instead

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
		(transaction costs of information asymmetries and opportunism)		
BG	Impact of the renegotiation process on the jurisdiction of the arbitral tribunal, related to the independent status of individual shareholders to the concessionaire company under the treaty	Artificial disconnection between the contract (and its evolution) and the treaty. Also, static, classical-contract-law interpretation of FET: legitimate expectations judged at the time the investment was made. Moreover, FET is independent from the principle of good faith. However, evolutionary interpretation of the minimum standard of treatment, as one that has evolved since the Neer case	disconnection between the treaty and the domestic law of the host state: Despite the controlling interest of BG in the concessionaire company (and its ensuing control of corporate-governance practices throughout the implementation of the contract), the tribunal held that the shareholder's claims under the treaty are independent of the renegotiation process under the domestic law of the host state	The tribunal conflated two different legal standards ("legitimate expectations" and minimum standard of treatment) by holding that Argentina's conduct fell below the international minimum standard because it breached the "specific commitments" that it made to the investor and, by extension, the principles of stability and predictability deemed to be inherent in the FET standard
Total	Reverse position from that of previous tribunals regarding the status of individual shareholders as	Mixed methodology: elements of relational contract theory, and comparative public law. Proxy of dynamism: flexible and inherently	Common-law approach regarding the emphasis of law as process, i.e. the legal relevance of the process of the renegotiation for	Renegotiation (and particularly the freezing of tariffs) could have been justified when

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	claimants for alleged treaty breaches resulting from a renegotiation of the concession contract. Different interpretation of "res inter alios acta", as the tribunal held that the Claimant could not rely on any contractual commitments made by the host state to the concessionaire company, and the concessionaire's License cannot be regarded as a source of contractual legal commitments	incomplete nature of FET, its content is an ad hoc one adapted to the circumstances of the case. Criticism of the VCLT's "ordinary meaning" rule and endorsement of Vivendi II's reference to general principles of international law. Proxy of mutuality: importance of embeddedness for evaluating FET, which derives from the overarching general principle of good faith. Also, the tribunal held that BITs "are not insurance policies against bad business judgments". Nevertheless, static approach to "legitimate expectations" identified with stability of the legal framework applicable when the investment was made. Comparative public law: drawing from GATS to interpret "specific commitments" as equivalent to "legitimate expectations"	deciding on the FET claim. Proxy of dynamism, as the tribunal differentiated between the pre-emergency and after-emergency periods	the Emergency Law was enacted and during the height of the crisis, provided that Argentina had subsequently renegotiated successfully the contracts and re-established their equilibrium. However, the inconclusive results of the renegotiation process entrusted by the government to the regulator amounted to unfair and inequitable treatment
National Grid	Due diligence of the investor, relationship between domestic and	Textualist interpretation pursuant to the "ordinary meaning" of Article 31	Tribunal refused to take a holistic view on contractual	Temporal, dynamic interpretation of

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	international law, disagreement of the parties on the legality of renegotiation as process	of the VCLT. The tribunal held that the "ordinary meaning" was too broad and imprecise, thus turning to the Preamble of the BIT. One-sided interpretation of the Preamble holding that its only purpose was to "encourage and protect" foreign direct investment. Nevertheless, proxy of mutuality in judging that the investor should not be shielded from ordinary business risk, and its expectations must be reasonable in light of the circumstances. Moreover, proxy of dynamism: temporal interpretation of FET	renegotiations by examining previous, investor-led renegotiations that took place before the last, emergency renegotiation	FET: the breach of FET did not occur at the time the renegotiation measures were taken to manage the crisis (in 2001), but they did occur when the emergency was over (from 2002 onwards), as a result of the failed renegotiation process during which the state imposed, inter alia, the obligation upon the investor to waive all its legal remedies linked to the concession contract

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
Hochtief	Renegotiation as regular practice of the parties (even before a crisis), acute corporate governance problems in the operation of the concessionaire, shareholder's reflective losses, international financing as a risky business	Artificial distinction between domestic and international law, and overly static, classical-contract-theory interpretative methodology: the tribunal separated artificially between the status of the claimant as a shareholder of the concessionaire company under Argentine domestic law, and its status under the treaty. Contradictory legal reasoning: whereas the legal form of the concession was considered relevant for defining the "legal stability" the Claimant was entitled to under the treaty, it was discarded as irrelevant for defining the specific treaty rights of the Claimant	Common-law approach, in the sense that the tribunal emphasized the process of renegotiation, and the way it was conducted as relevant for its compliance with the treaty	Distinction between the renegotiation as a legal consequence of hardship and the process itself for renegotiated the concession contracts. It was not renegotiation per se but the manner in which the process was implemented, namely the continued delays and complete lack of due process, that constituted a breach of FET. Had it been practicable for the parties to reach a renegotiated agreement, when the investor was also willing to do so, the Claimant would have been estopped from bringing a claim under the treaty
Suez	Characteristic example of	Rejection of the first two elements of Article 31 of	Disregard for the legal significance of the pre-	The renegotiation itself frustrated

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	renegotiation as common practice of the parties and the invisibility of investor-led renegotiations under international law, Dissenting Opinion of Arbitrator Nikken	the VCLT, i.e. textualist and contextualist methods. Regarding the "object and purpose" of the BIT, the tribunal partially endorsed the relational proxy of mutuality by holding that all BITs have broader goals than just investors' protection. But, static, classical-contract-theory approach to "legitimate expectations". One-sided endorsement of the relational-contract-theory approach in evaluating the pre-crisis, investor-led renegotiations	crisis, investor-led renegotiations. The tribunal did not evaluate them, but only held that they indicated the cooperative, well-functioning relationship between the parties in the early years of the concession	the investor's legitimate expectations for the legal and business stability of the concession. Nikken dissented and held that the international legal standard for judging the legality of a renegotiation in the event of "hardship" was the obligation of the parties to negotiate an adaptation to the changed circumstances. As a result, there was a violation of FET due to renegotiation only for the period following consolidation of the recovery from the economic and social crises that Argentina suffered

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
El Paso	Direct application of the UNIDROIT Principles of International Commercial Contracts in deciding the defenses of the host state	Relational approach endorsing the interpretative proxy of dynamism: the tribunal followed the Continental award in recognizing the variance of the FET standard. Moreover, proxy of mutuality: importance of "embeddedness" for evaluating the investor's legitimate expectations	Emphasis on the defenses of the host state, namely the distinction between the state of necessity under Article 25 of the ILC Articles on State Responsibility and the Non-Precluded Measures clause under the BIT	The tribunal found Argentina in breach of FET and rejected its necessity defense
Azurix	Problem of the production of evidence, particularly regarding opportunistic renegotiations. Complex corporate governance structures impacting the sustainability of the concession. Enron-related corruption claim referring to an earlier renegotiation	Textualist approach based on Article 31(1) of the VCLT. Element of common-law approach in that the tribunal relied on precedent.	No causation analysis between the disputed renegotiation and the concessionaire's incapability of securing financing, thus meeting its commercial obligations for the concession. Similarly, one-sided the tribunal's approach to earlier, investor-led renegotiations, especially the one shortly after the award of the contract through competitive bidding. Despite the fact that the regulator requested from the concessionaire to present a detailed cost study justifying the changes in its cost structure and the	Breach of FET because of the politicization of the tariff regime due to the coming elections

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
			potential repercussions for users, the concessionaire refused to produce such study	
Biwater	Exemplary (if not unique) case where the tribunal sanctioned the government's decision not to succumb to the investor's opportunistic request for renegotiation. Two elements standing out: the use of an independent mediator by the host state, and the causation analysis by the tribunal. Submission of amici curiae briefs	Relational contract theory approach, heavily evidence-based. The tribunal gathered and evaluated all material evidence, including that submitted by the mediator, as well as the internal communication in the corporate group on their renegotiation strategies. Proxy of mutuality in interpreting FET: relevance of investor's due diligence and limit to legitimate expectations placed by "embeddedness" and the investor's risk-taking strategies	Strong connection between contract and treaty claims in evaluating whether the renegotiation constituted a treaty breach. The tribunal reasoned that treaty standards are deeply related (relational contract theory approach) to the way the contract and the relationship of the parties have evolved, and the investor's conduct should be taken equally into account in determining its legitimate expectations	No breach of FET as result of the failed renegotiation process between the host state and the concessionaire. The contract did not entitle the investor to a "general needs" review, and Tanzania had no legal obligation to make the radical changes that the investor requested, but still it entered into renegotiations in good faith
Fraport	Evaluation of the investor's renegotiation practices already in determining whether the Claimant had an "investment" in the host state in the first place. Investor submitted	Approach connecting the contract and the treaty, and domestic law and international law. The tribunal insisted on the production of evidence, and examined the shareholders agreements and other internal documents to find that	The tribunal inferred from the conditions under which the renegotiations took place, that they were both opportunistic and of dubious legality. They also lacked the approval of the regulatory authorities	The lack of transparency and the withholding of information from the part of the concessionaire resulted in the rejection by the tribunal of the

Cases	Main Issues	Interpretative approach	Legal standard for renegotiation	Outcome
	renegotiation request very shortly after the award of the concession, in fact only months afterwards. Illegal corporate governance practices	the Claimant was consciously, intentionally, and covertly structuring its investment in such a way as to violate the domestic law of the host state		investor's claim of breach of FET as a result of the last contractual renegotiation

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