A Contractual Approach to Investor-State Regulatory Disputes

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Article

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INTRODUCTION

In 2010, Philip Morris International filed a complaint against Uruguay alleging that certain regulations on cigarette packaging violated the bilateral investment treaty (BIT) between Uruguay and the company's home state of Switzerland.[1] In its request for arbitration, Philip Morris claimed that the government's anti-smoking legislation decreased the value of the company's investments in the country in violation of Uruguay's obligation under the BIT to provide fair and equitable treatment to Swiss investors.[2] Among other things, the legislation requires that eighty percent of the surface area of cigarette

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1. *See* FTR Holdings SA v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Request for Arbitration (Feb. 19, 2010) [hereinafter Philip Morris, Request for Arbitration].

2. *Id.* ¶ 77.

packaging be devoted to health warnings, and that the packaging include "graphic images . . . to illustrate the adverse health effects of smoking."[3] The arbitral tribunal in which the claim was filed recently determined that it had jurisdiction over at least some of Philip Morris's claims, and the arbitration is now proceeding on the merits.[4]

The case just described is representative of an increasingly common problem confronting international investment arbitral tribunals. It involves a "regulatory dispute" in which Philip Morris is challenging the validity of a generally applicable regulation. In contrast to an earlier phase of international investment law when disputes primarily concerned outright expropriations of the property of foreign nationals,[5] recent claims like Philip Morris's increasingly challenge conduct that is not necessarily an attempt by the host state to extract value from the foreign enterprise. Rather, such disputes involve what may be genuine efforts by the government to promote the public welfare through regulation, with an impact on foreign investors that is incidental to the government's objectives. Nonetheless, a claim like Philip Morris's is at least a viable one because the fair and equitable treatment obligation that exists in most BITs has been construed to require a degree of regulatory stability, and does not require claimants to show bad faith or other wrongful state conduct.[6]

Investment tribunals are thus faced with a seemingly intractable conflict between the rights of foreign investors and the prerogative of host states to regulate in the public interest. Their involvement in such sensitive disputes has triggered concerns about the legitimacy of the entire system of investor-state dispute settlement. Commentators question whether privately appointed foreign arbitrators should have the power to rule on the validity of "public interest regulations" enacted by "democratically elected governments."[7] States have withdrawn from international investment treaties or threatened to do so, citing process concerns in decisions to award large damages to foreign investors.[8] And such concerns are not felt by developing states alone. As capital increasingly flows into as well as out of developed nations, these states are likewise concerned about the impact of investor-state dispute settlement on domestic policymaking and about whether the continued inclusion of such provisions is appropriate.[9]

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3. Philip Morris Brands Sàrl v. Oriental Republic of Uru., ICSID Case No. ARB/10/7, Decision on Jurisdiction, ¶¶ 5, 7 (July 2, 2013) [hereinafter Philip Morris, Decision on Jurisdiction].

4. *See id*. ¶ 236. Philip Morris has raised similar challenges to marketing regulations in other countries. *See, e.g*., Philip Morris Asia Ltd. v. Commonwealth of Austl., PCA Case No. 2012-12, Notice of Arbitration (Nov. 21, 2011).

5. *See* Steven R. Ratner, *Regulatory Takings in Institutional Context: Beyond the Fear of Fragmented International Law*, 102 AM. J. INT'L L. 475, 475 (2008).

6. *See* RUDOLF DOLZER & CHRISTOPH SCHREUER, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW 147 (2d ed. 2012).

7. Barnali Choudhury, *Recapturing Public Power: Is Investment Arbitration's Engagement of the Public Interest Contributing to the Democratic Deficit?*, 41 VAND. J. TRANSNAT'L L. 775, 779 (2008).

8. *See* Oscar Lopez, *Smart Move: Argentina To Leave the ICSID*, 1 CORNELL INT'L L.J. ONLINE 121, 122-25 (2013).

9. For example, Australia previously announced that it would no longer include investor-state dispute settlement in its investment treaties, though a new government has backtracked on that stance.

The approach taken by investment tribunals to regulatory disputes had been evolving even as these critiques were circulating. But the view that now predominates among commentators, and that is gaining traction among tribunals, is known as the "public law framework." The basic premise of the public law approach is that disputes like the one between Philip Morris and Uruguay are analogous to lawsuits by individuals challenging state regulations under domestic constitutional or administrative law.[10] According to this view, investment treaties, like domestic public law, contain certain limitations on state power and permit individuals to challenge actions that exceed the state's authority or violate individual rights. Thus, proponents of the public law approach argue that regulatory disputes would best be resolved using tools developed in domestic public law to address analogous conflicts between individual rights and state sovereignty.

The public law approach has a superficial appeal, but the analogy ultimately breaks down in the particulars. One proposed method of resolving regulatory disputes is the adoption of a proportionality test. Advocates of this approach suggest that tribunals should weigh the state's legitimate regulatory interests on the one hand and the investor's legitimate expectations on the other to determine whether the enacted measure is proportional.[11] The problem with this proposal is that it is fundamentally indeterminate, requiring the tribunal to weigh incommensurable values. As described in further detail below, there is no way to balance such values without engaging in policy judgments, and while we may be comfortable with affording domestic courts that authority, there are reasons to think that international arbitrators lack the legitimacy and expertise to perform that function. Indeed, even scholars who advocate proportionality in domestic judicial review implicitly recognize that its use by foreign adjudicators not embedded in the relevant political community would not be proper.[12]

A second set of proposals for resolving regulatory disputes may be grouped under the heading "deferential approaches." These approaches would largely avoid the proportionality test's indeterminacy problems by resolving any close questions in the state's favor. States would be afforded wide latitude to regulate as they see fit, subject only to review for concerns like irrationality or arbitrariness as provided for in domestic public law.[13] Even this approach,

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See The Arbitration Game: Governments Are Souring on Treaties To Protect Foreign Investors, ECONOMIST, Oct. 11, 2014, http://www.economist.com/news/finance-and-economics/21623756-governments-are-souring-treaties-protect-foreign-investors-arbitration. In the course of negotiations over the Trans-Atlantic Trade and Investment Partnership (TTIP), there has been widespread popular opposition, particularly within the European Union, to the proposed inclusion of investor-state dispute settlement. *See* Jan Kleinheisterkamp, *Who Is Afraid of Investor-State Arbitration? Unpacking the Riddle of 'No Greater Rights' in the TTIP*, INVESTMENT TREATY NEWS, Nov. 18, 2014, http://www.iisd.org/itn/2014/11/18/who-is-afraid-of-investor-state-arbitration-unpacking-the-riddle-of-no-greater-rights-in-the-ttip.

10. *See* GUS VAN HARTEN, INVESTMENT TREATY ARBITRATION AND PUBLIC LAW 4 (2007).

11. *See, e.g.*, Saluka Investments BV v. Czech Republic, Partial Award, ¶ 306 (UNCITRAL Arb. Trib. Mar. 17, 2006) [hereinafter *Saluka Investments*], http://www.italaw.com/documents/Saluka-PartialawardFinal.pdf.

12. *See infra* note 104 and accompanying text.

13. *See* Anna T. Katselas, *Do Investment Treaties Prescribe a Deferential Standard of*

however, creates legitimacy concerns because tribunals would be required to exercise some policymaking authority in drawing the boundaries of permissible action. Moreover, a deferential posture cannot be justified by analogy to domestic public law. Those who attempt to do so overlook important ways in which the relationship between a host state and a foreign investor differs from that between the state and its own nationals. In short, the primary tools that public law proponents have attempted to incorporate into the international investment law context are unlikely to produce a principled jurisprudence and threaten to exacerbate the "legitimacy crisis" already plaguing international investment tribunals.[14]

There is a still more fundamental problem with the public law approach: it too readily dispenses with the question of the contracting states' intent. No one disputes that the contracting states' intent would govern if it could be clearly discerned. But most investment treaties do not define the vague phrase "fair and equitable treatment" or otherwise explain how it should apply to disputes involving genuine efforts by the host state to regulate in the public interest. In the absence of clear textual guidance, proponents of the public law approach leap too quickly to tests like proportionality that are not designed to approximate the states' intent and indeed result in some degree of policymaking by the tribunals themselves.[15]

This Article suggests a different path. I argue that investment tribunals should look to contract law and theory for new tools to address the challenge posed by regulatory disputes. The basic analogy of treaty to contract is well established. Like private actors who enter into a contract, states enter into treaties to make credible, binding commitments and thereby facilitate cooperation between or among themselves.[16] In contract law, when the parties' intent is not made clear in the text of the agreement, courts do not simply abandon the search and substitute their own judgment; they employ other tools to approximate what the parties would have wanted.[17] Surprisingly, although

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Review?, 34 MICH. J. INT'L L. 87, 149 (2012).

14. Susan D. Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions*, 73 FORDHAM L. REV. 1521, 1523 (2005). Professor Franck's description of the legitimacy crisis emphasizes the problem of inconsistent decisions and the lack of any mechanism available to reconcile them. *See id*. at 1582-83. As described in the main text, other legitimacy concerns have been raised as well.

15. Professor Einer Elhauge describes a similar concern about how one model of judging encourages courts to exercise independent discretion in statutory interpretation: "Under [this view], judges are to act as honest agents for the legislature to the extent they can divine its meaning using traditional methods of legal interpretation. But once those methods give out, judges must instead shift to becoming independent lawmakers, furthering the normative views . . . they themselves find most attractive." EINER ELHAUGE, STATUTORY DEFAULT RULES 3 (2008). My argument resembles Elhauge's in structure: we both propose that there are other steps that judges or arbitrators can take to approximate the principals' intent even after the core methods of interpretation, like text and purpose, "give out." *Id*.

16. *See* ROBERT E. SCOTT & PAUL B. STEPHAN, THE LIMITS OF LEVIATHAN: CONTRACT THEORY AND THE ENFORCEMENT OF INTERNATIONAL LAW 59 (2006); *see also* ERIC A. POSNER & ALAN O. SYKES, ECONOMIC FOUNDATIONS OF INTERNATIONAL LAW 24 (2012).

17. *See* Paul B. Stephan, *Courts on Courts: Contracting for Engagement and Indifference in International Judicial Encounters*, 100 VA. L. REV. 17, 20 (2014) ("Modern contract theory posits that courts should and do fulfill their mandates by attempting to ascertain the instructors' preferences and not their own.").

international law scholars have borrowed other concepts from contract theory,[18] relatively little has been said about how the tools of contract interpretation could be adapted to the treaty context.[19] That is the task I attempt here.

Extending the basic analogy to the present context, I argue that tribunals should pay greater attention to the intent of the contracting states in resolving regulatory disputes. As I explain further below, most international investment takes place under the terms of a BIT created by two contracting states to facilitate long-term economic cooperation between them. That only two parties are typically involved makes the analysis simpler than if the treaty had to be interpreted with reference to the intent of a larger group. In any event, the precise question presented by a regulatory dispute is whether the host state's changes to its regulatory framework fall within the intended scope of a fair and equitable treatment obligation that BITs generally fail to define. Drawing on concepts and principles from contract law and theory, I show how tribunals could fill this gap in the typical BIT in a way that respects the contracting states' intent. I explore three specific tools: a default rule approach and two default standards derived from contract law's analysis of changed circumstances.

The argument for a contractual approach is a functional one. I do not claim that recourse to contract principles is required by treaty text or has another basis in existing international law. I argue instead that a contractual approach is functionally superior to the public law alternative because it would enable tribunals to decide regulatory disputes based on legal principle rather than policy judgments. Likewise, shifting the focus to the parties' intent reduces the legitimacy concerns afflicting the public law approach because the tribunals would no longer be reviewing the substance of state regulations. By focusing on what the contracting states themselves would likely have intended fair and equitable treatment to encompass, investment tribunals could avoid independently assessing the validity of state action as a domestic court performing judicial review would. In sum, by engaging in more principled reasoning and issuing decisions from a stronger position of legitimacy, tribunals would be better able to sustain a dispute settlement regime that is increasingly under attack and thus to play their role in facilitating the long-term economic cooperation that investment treaties seek to achieve.

A few caveats are in order before proceeding. First, the scope of this Article is limited to good-faith exercises of regulatory authority by host states. Existing doctrine already recognizes that bad faith and other types of wrongful host state conduct are inconsistent with the fair and equitable treatment guarantee, and my proposal is not intended to interfere with that.[20] Second, it is

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18. For example, Professors Robert Scott and Paul Stephan use contract theory to illuminate the tradeoff in international law between formal and informal enforcement. *See* SCOTT & STEPHAN, *supra* note 16, at 7. One scholar has applied contract theory to international investment law specifically, but her analysis seeks to explain the economic logic of state behavior rather than provide interpretive tools for tribunals. *See* Anne van Aaken, *International Investment Law Between Commitment and Flexibility: A Contract Theory Analysis*, 12 J. INT'L ECON. L. 507, 508-09, 515 (2009).

19. For exceptions, see *infra* notes 118, 122, and 123 and accompanying text.

20. *See* DOLZER & SCHREUER, *supra* note 6, at 156-58; *see also infra* notes 52-53 and

worth clarifying that while the contracting parties are the two states entering into the BIT, most investment disputes are between a foreign investor and a host state. If the BIT is the contract, the investors are intended third-party beneficiaries. This may create some wrinkles because the contract law tools I discuss were not designed with third-party beneficiaries in mind, but I believe the principles can be translated.

Finally, many regulatory disputes also involve claims of indirect or "creeping" expropriations, which are the equivalent of regulatory takings in U.S. law.[21] I focus in this Article on fair and equitable treatment because it is generally considered the most important standard in investment treaty arbitration.[22] Claims of indirect expropriations face a higher bar, and the fact that more extreme conduct is generally required makes them less of a threat to state sovereignty, relatively speaking.[23] Moreover, some BITs prescribe more detailed doctrinal tests for expropriations that may not leave room for tribunals to import contract principles.[24] Thus, while I do not rule out the possibility that the proposals here could inform the analysis of indirect expropriation claims, I bracket that question for present purposes to ensure a clearer and more focused discussion of fair and equitable treatment.[25]

The Article proceeds in three parts. Part I begins with a brief overview of international investment law. Part II explains the general theory of the public law approach, which advocates greater sensitivity to the regulatory concerns of states acting in their sovereign capacities. It then describes some specific doctrinal solutions that have been proposed and presents my critique of these proposals as difficult to administer and likely to exacerbate existing concerns about the legitimacy of tribunals. Part III makes the general case for a contractual approach that would improve on the deficiencies of the public law approach by bringing the contracting states' intent back to the foreground. It then explores three tools developed in contract law to approximate the parties' intent in the face of a contractual gap and shows how they could be usefully

accompanying text.

21. *See* DOLZER & SCHREUER, *supra* note 6, at 101-04.

22. *See* Katselas, *supra* note 13, at 108 (similarly focusing on fair and equitable treatment because "it is raised in most disputes and is the basis for most successful claims").

23. *See* DOLZER & SCHREUER, *supra* note 6, at 102-03.

24. The United States Model BIT, for example, prescribes "a case-by-case, fact-based inquiry that considers, among other factors: (i) the economic impact of the government action . . . ; (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and (iii) the character of the government action." *2012 U.S. Model Bilateral Investment Treaty*, U.S. DEP'T OF STATE, Annex B(4), http://www.state.gov/documents/organization/188371.pdf (last visited Apr. 16, 2015). This framework, of course, is identical to the test for regulatory takings established in *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978). The test has now been incorporated into other countries' model BITs and investment treaties to which the United States is not a party. *See* Anthony B. Sanders, *Of All Things Made in America Why Are We Exporting the* Penn Central *Test?*, 30 NW. J. INT'L L. & BUS. 339, 344 (2010).

25. Relatedly, some foreign investors also bring breach of contract claims based on agreements they have directly with the host state. *See generally* Sam Foster Halabi, *Efficient Contracting Between Foreign Investors and Host States: Evidence from Stabilization Clauses*, 31 NW. J. INT'L L. & BUS. 261 (2011). I bracket those types of claims as well because any relevant contract law principles can be applied more directly and do not require the translation I attempt here to the treaty context.

adapted to the present context.

I. INTERNATIONAL INVESTMENT LAW OVERVIEW

This Part provides a brief primer on the modern international investment law regime. Others have provided more comprehensive histories of the development of this regime, and I do not want to repeat too much of that here.[26] My account will spend more time on details that are relevant to the specific investor-state regulatory disputes that are the focus of this Article.

International investment law developed to promote economic exchange between states by reducing the risks of investing in foreign countries, particularly those with relatively immature legal systems. Firms were reluctant to invest in such states because they knew that these states had an incentive to change the rules and thereby extract greater value for themselves after the investor had committed resources and otherwise sunk costs into the project.[27] In the early days of international investment, firms were primarily concerned about outright expropriations, meaning that the host state would simply take property for its own use.[28] Over time, investors also sought compensation when the state did not directly expropriate property, but instead indirectly diminished the value of an investment through changes to the regulatory framework.[29]

As domestic law was not thought to be adequate to protect against such interference,[30] international investment law emerged as a response to these concerns. The difficulty lay in balancing the competing interests of states that wished to export capital under the most investor-friendly conditions and states that wished to import capital in a way that maximized their growth prospects. Because investment flowed primarily from developed to developing states, the former pushed for strong investment protections, including a standard for compensation that required states to pay "prompt, adequate, and effective" compensation for any expropriations.[31] Over time, developing states pushed back on the views of developed nations, creating uncertainty about the content of customary international law.[32] This led to a period in which several movements to create a multilateral treaty governing international investment and thereby resolve the uncertainties were attempted without success.[33]

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26. *See, e.g.*, Franck, *supra* note 14, at 1524-45 (describing the evolution of the BIT regime and the mechanics of the investment arbitration process); Anthea Roberts, *Clash of Paradigms: Actors and Analogies Shaping the Investment Treaty System*, 107 AM. J. INT'L L. 45, 49-75 (2013) (providing an overview of the various intellectual perspectives that shaped and continue to influence the regime).

27. *See* Halabi, *supra* note 25, at 268.

28. *See* Ratner, *supra* note 5, at 475.

29. *Id*.

30. *See* Choudhury, *supra* note 7, at 781 (noting that "investors rarely found success litigating against the host state in its own courts").

31. This is known as the Hull Rule, named after Secretary of State Cordell Hull, who asserted this standard during a dispute between the United States and Mexico over the latter's confiscation of various American-owned properties in the early twentieth century. *See* Andrew T. Guzman, *Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639, 645 (1998).

32. *See id*. at 646-51.

33. *See* DOLZER & SCHREUER, *supra* note 6, at 8-11.

While these efforts were ongoing, states turned to bilateral negotiations to establish rules to govern international investment. The movement began in 1959, led by European nations like Germany, Switzerland, and France.[34] The United States followed suit in 1982 and to date has concluded approximately forty BITs.[35] There are an estimated 3,000 BITs currently in operation.[36] Developing states now establish BITs with each other, and it is no longer unusual for investment to flow from developing to developed nations.[37] Although no major multilateral agreement has been concluded, a number of regional agreements, such as the North American Free Trade Agreement (NAFTA), include provisions that are largely similar to those contained in BITs.[38]

The empirical evidence on whether BITs have been successful is mixed. There is support for the conclusion that the presence of a BIT attracts foreign investment,[39] although some doubts have been raised even on that score.[40] But of course increasing investment flows is only part of the goal. The larger concern is whether the developing countries that aggressively compete for foreign investment are actually seeing any benefits in terms of their own growth. On this question there is greater cause for skepticism, as evidence suggests that foreign investment comes to developing countries on such unfavorable terms that they end up extracting minimal benefit from the arrangement.[41] At the same time that the *economic* value of BITs is being questioned, BITs are having a substantial *political* impact in the form of constraints on state sovereignty, leading some to wonder whether the "grand bargain" is worth maintaining.[42]

Notwithstanding the above concerns, what cannot be doubted is the global importance that BITs have attained. In the absence of a multilateral treaty, most international investment takes place under the terms of a BIT.[43]

34. *Id*. at 6-7.

35. *United States Bilateral Investment Treaties*, U.S. DEP'T OF STATE, http://www.state.gov /e/eb/ifd/bit/117402.htm (last visited Apr. 16, 2015).

36. DOLZER & SCHREUER, *supra* note 6, at 13.

37. *See* Anthea Roberts, *Power and Persuasion in Investment Treaty Interpretation: The Dual Role of States*, 104 AM. J. INT'L L. 179, 196 (2010).

38. DOLZER & SCHREUER, *supra* note 6, at 15. Likewise, the Energy Charter Treaty, which promotes international cooperation in the energy sector, includes provisions addressing international investment, and arbitral decisions made under that treaty are sometimes cited as persuasive authority in cases brought under BITs. *See id*.; STEPHAN W. SCHILL, THE MULTILATERALIZATION OF INTERNATIONAL INVESTMENT LAW 311-12 (2009).

39. *See* Lisa E. Sachs & Karl P. Sauvant, *BITs, DTTs, and FDI Flows: An Overview*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT xxvii, liii-lvii (Karl P. Sauvant & Lisa E. Sachs eds., 2009) (summarizing these studies).

40. *See* Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract FDI? Only a Bit . . . And They Could Bite*, *in* THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT, *supra* note 39, at 349, 368.

41. *See* Joshua Boone, *How Developing Countries Can Adapt Current Bilateral Investment Treaties To Provide Benefits to Their Domestic Economies*, 1 GLOB. BUS. L. REV. 187, 191-92 (2011).

42. *See* Hallward-Driemeier, *supra* note 40, at 374-75. The term "grand bargain" comes from Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 HARV. INT'L L.J. 67, 77 (2005).

43. *See* DOLZER & SCHREUER, *supra* note 6, at 13 (noting that "BITs are the most important source of contemporary international investment law").

Moreover, it makes sense to study BITs as a distinctive regime because the major provisions across the thousands of BITs that have been concluded are "remarkably similar."[44] The drive toward cohesion is further reinforced when investment tribunals choose to cite each other's decisions as persuasive authority, including when they interpret similar provisions in different BITs.[45] All of this has led some to observe that international investment is now governed by what is a de facto multilateral regime.[46]

The typical BIT includes provisions on the substantive standards for investment protection as well as on dispute settlement procedures. The substantive provisions address issues such as the admission of investment into the host state, compensation requirements for expropriations, guarantees of full protection and security, and guarantees against arbitrary and discriminatory treatment.[47] With regard to dispute resolution, most BITs contain advance consent to arbitration by each state for disputes that investors of the other state may initiate.[48] The most popular arbitral forum is the International Centre for Settlement of Investment Disputes (ICSID), which was established in 1966 and has now adjudicated over 300 investor-state disputes.[49] The cumulative effect of these provisions is a robust set of protections for foreign investors and the assurance of a neutral arbiter for any disputes they may have with the host state.

Most relevant for present purposes, the typical BIT includes a provision requiring "fair and equitable treatment" of investors from the other contracting state. The term originated in early U.S. treaties on friendship, commerce, and navigation.[50] The various drafts of failed multilateral agreements included the term, and it appears in NAFTA as well as the majority of BITs.[51] There is some variation in precisely where the term appears or in the language that surrounds it, but it is generally understood to serve as a catchall provision for wrongful state conduct and thus is purposely open-ended.[52] The standard has in fact been used to address a broad range of concerns, including the denial of due process, coercion and harassment, and failures to implement or enforce national laws.[53]

Some commentators and a handful of tribunals take the view that fair and equitable treatment is not a distinct treaty-based standard, but instead is meant

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44. Franck, *supra* note 14, at 1529.

45. *See* SCHILL, *supra* note 38, at 322-23, 326.

46. *See id*. at 15-16 ("BITs in their entirety, it is argued, function analogously to a truly multilateral system as they establish rather uniform general principles that order the relations between foreign investors and host States in a relatively uniform manner independently of the sources and targets of specific transborder investment flows.").

47. DOLZER & SCHREUER, *supra* note 6, at 13.

48. *Id*.

49. *Id*. at 239, 241; *List of Concluded Cases*, ICSID, http://icsid.worldbank.org/apps/ICSIDWEB/cases/Pages/AdvancedSearch.aspx?cs=CD28 (last visited Apr. 16, 2015).

50. DOLZER & SCHREUER, *supra* note 6, at 131.

51. *Id*. at 131-32.

52. Ioana Knoll-Tudor, *The Fair and Equitable Treatment Standard and Human Rights Norms*, *in* HUMAN RIGHTS IN INTERNATIONAL INVESTMENT LAW AND ARBITRATION 310, 311-16, 318 (Pierre-Marie Dupuy et al. eds., 2009); *see also* DOLZER & SCHREUER, *supra* note 6, at 132.

53. Knoll-Tudor, *supra* note 52, at 322-35.

to incorporate the customary international law concept of an "international minimum standard."[54] Such an approach would prohibit outright takings and other bad-faith behavior, but would likely not extend to good-faith regulations in the public interest that affected foreign investment only incidentally.[55] Most tribunals, however, have concluded that fair and equitable treatment is an independent standard that goes beyond the international minimum and requires some degree of stability in the legal and regulatory framework governing the investment.[56]

The importance of stability is reflected in a commonly cited definition of the standard's general contours, formulated by the ICSID tribunal in *Tecmed v. Mexico*[57]:

> The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it 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.[58]

Other tribunals have used phrases like "the stability of the legal and business framework."[59] Sometimes the concept of stability is mentioned in the BIT itself, but tribunals have incorporated the principle even in the absence of such reference.[60]

It bears emphasizing that, while evidence of bad faith may be sufficient to trigger host state liability, it is not a necessary condition. Yet it cannot be the case that every departure from regulatory stability gives rise to potential

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54. DOLZER & SCHREUER, *supra* note 6, at 134. As Dolzer and Schreuer note, this position is difficult to defend as a textual matter. *Id.* However, the three NAFTA parties decided to adopt this atextual understanding in an interpretive note after several tribunals had held otherwise. *See* Patrick Dumberry, *Moving the Goal Post!: How Some NAFTA Tribunals Have Challenged the FTC Note of Interpretation on the Fair and Equitable Treatment Standard Under NAFTA Article 1105*, 8 WORLD ARB. & MEDIATION REV. 251, 251-52 (2014). The United States then extended this approach to its BIT program by explicitly limiting fair and equitable treatment to the international minimum standard in recent BITs. *See 2012 U.S. Model Bilateral Investment Treaty*, U.S. DEP'T OF STATE, art. 5, http://www.state.gov/documents/organization/188371.pdf (last visited Apr. 16, 2015). But these attempts to limit the meaning of fair and equitable treatment have not settled the matter even for NAFTA and the recent U.S. BITs. Some tribunals have concluded that the customary international law minimum standard has evolved, and at least one has concluded that the standard has evolved to the point of being equivalent to the distinct treaty-based principle. *See* Dumberry, *supra*, at 271-72.

55. *See* Glamis Gold, Ltd. v. United States, Award, ¶ 22 (NAFTA Ch. 11 Arb. Trib. June 8, 2009), http://www.italaw.com/sites/default/files/case-documents/ita0378.pdf (describing the traditional international minimum standard as requiring an act that is "sufficiently egregious and shocking—a gross denial of justice, manifest arbitrariness, blatant unfairness, a complete lack of due process, evident discrimination, or a manifest lack of reasons").

56. *See* Benedict Kingsbury & Stephan Schill, *Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality, and the Emerging Global Administrative Law*, *in* 50 YEARS OF THE NEW YORK CONVENTION: ICAA CONGRESS SERIES NO. 14, at 5, 16 (Albert Jan van den Berg ed., 2009) ("International investment treaty tribunals have repeatedly associated fair and equitable treatment with stability, predictability, and consistency of the host State's legal framework.").

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

58. *Id.* ¶ 154.

59. LG&E Energy Corp. v. Arg. Republic, ICSID Case No. ARB/02/1, Decision on Liability, ¶ 125 (Oct. 3, 2006).

60. *See* DOLZER & SCHREUER, *supra* note 6, at 147-48.

liability. Those points underscore the central dilemma posed by regulatory disputes and the question on which this Article is focused: when should a generally applicable regulation enacted to promote the public interest constitute a violation of the fair and equitable treatment guarantee? Before explaining how I would approach that question in Part III, I turn in the next Part to consider other solutions that have been tried or proposed.

II. THE PUBLIC LAW APPROACH

The increasingly accepted view on how tribunals should resolve regulatory disputes that pit investor rights against state sovereignty is known as the public law approach. This Part begins by describing the investor rights approach that prevailed in the early days of international investment law before explaining the general theory underlying the public law approach. It then details two attempts to implement that general theory—the proportionality test and a set of approaches that apply deferential review—and provides a critique of each one.

A. *The Investor Rights Approach*

Before delving into the public law approach, it will be useful to understand the investor rights approach that it is gradually replacing. The investor rights approach sees the primary function of international investment law as protecting the fundamental rights of investors and analyzes disputed issues through that lens.[61] Its dominance in the early days of international investment law likely reflected the influence of the lawyers involved who had come from the world of international commercial arbitration and were less attuned to the concerns of sovereign states.[62] Moreover, proponents of the approach generally believed strongly in the sanctity of property rights, viewing them on par with other human rights,[63] or else believed from a more instrumental perspective that investment protection serves a vital economic development purpose.[64] In any event, the general principle was that, similar to other individual rights that can be asserted as trump cards against the state, rights granted under investment treaties may often take precedence over state interests.[65]

Tribunals taking such an approach did not necessarily employ an explicitly distinct doctrinal test. Rather, their pro-investor bent was evident in the way they described their task and the purpose of the BIT as fundamentally about investment protection above all else. For example, the tribunal in *SGS v.*

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61. *See* VAN HARTEN, *supra* note 10, at 136.

62. *See* Roberts, *supra* note 26, at 77.

63. *See* Charles H. Brower II, *NAFTA's Investment Chapter: Initial Thoughts About Second-Generation Rights*, 37 VAND. J. TRANSNAT'L. L. 1533, 1546-48 (2003). Some tribunals in fact drew analogies to human rights to support their broad understanding of investment protection. *See* VAN HARTEN, *supra* note 10, at 136 & n.65 (collecting examples).

64. *See* Donald Francis Donovan, *Introduction to Articles – Dallas Workshop on Arbitrating with Sovereigns*, 18 ARB. INT'L 229, 229 (2002).

65. *See* VAN HARTEN, *supra* note 10, at 136-37.

Philippines described the Philippines-Switzerland BIT as follows: "The BIT is a treaty for the promotion and reciprocal protection of investments. According to the preamble it is intended 'to create and maintain favourable conditions for investments by investors of one Contracting Party in the territory of the other.'"[66] This view of the BIT's overarching purpose would then influence the process of interpretation, as when the tribunal in *SGS* determined that it was "legitimate to resolve uncertainties . . . so as to favour the protection of covered investments."[67]

Applying that perspective to the meaning of fair and equitable treatment, the tribunal in *Azurix v. Argentine Republic* explained why this term should be understood broadly:

> The standards of conduct agreed by the parties to a BIT presuppose a favorable disposition towards foreign investment, in fact, a pro-active behavior of the State to encourage and protect it. To encourage and protect investment is the purpose of the BIT. It would be incoherent with such purpose and the expectations created by such a document to consider that a party to the BIT has breached the obligation of fair and equitable treatment only when it has acted in bad faith or its conduct can be qualified as outrageous or egregious.[68]

In finding that Argentina had violated its fair and equitable treatment obligation, the tribunal conducted an abbreviated analysis. It is evident, however, that substantial attention was paid to interference with investment, while minimal concern was shown for the objectives that the host state was seeking to fulfill.[69] As noted earlier, an investor rights approach may not involve a distinct doctrinal test. Instead, the practical consequence of the stance taken in *Azurix* is often subtler, as when the tribunal in that case gave weight to only one side's concerns and largely overlooked any countervailing considerations.[70]

The investor rights approach has been widely criticized, and the tribunals appear to be moving away from it.[71] The primary critique of the investor rights approach is that it reflects an overly narrow conception of the purpose of international investment law. As has been increasingly recognized by the tribunals themselves, investment treaties are designed to facilitate economic cooperation in a broader sense, and maximizing investment protection in every

66. SGS Société Générale de Surveillance S.A. v. Republic of the Phil., ICSID Case No. ARB/02/6, Objections to Jurisdiction, ¶ 116 (Jan. 24, 2004).

67. *Id*.

68. Azurix Corp. v. Arg. Republic, ICSID Case No. ARB/01/12, Award, ¶ 372 (July 14, 2006).

69. *See id*. ¶¶ 373-77.

70. A similar course was followed in *Occidental Exploration & Production Co. v. Ecuador*, LCIA Case No. U.N. 3467, Final Award (2004). In finding a violation of the fair and equitable treatment obligation, the tribunal emphasized that the claimant had relied on certain tax policies in place at the time of its investment, noted the importance of stability in the legal framework for business planning, and concluded that the changes made by Ecuador improperly frustrated the claimant's expectations without discussing Ecuador's asserted justifications. *See id*. ¶¶ 180-92; *see also* Roberts, *supra* note 37, at 215 & n.16 (citing this case to illustrate reasoning that was overly protective of investors).

71. Roberts, *supra* note 26, at 78 ("Approaches that focus attention on the state as a treaty party and regulatory sovereign are ascending in value, while those that draw comparisons with private law or that narrowly focus on the importance of investor protections are declining in value.").

instance at all costs would be shortsighted. The tribunal in *Saluka Investments v. Czech Republic* explained it this way:

> The protection of foreign investments is not the sole aim of the Treaty, but rather a necessary element alongside the overall aim of encouraging foreign investment and extending and intensifying the parties' economic relations. That in turn calls for a balanced approach to the interpretation of the Treaty's substantive provisions for the protection of investments, since an interpretation which exaggerates the protection to be accorded to foreign investments may serve to dissuade host States from admitting foreign investments and so undermine the overall aim of extending and intensifying the parties' mutual economic relations.[72]

With tribunals and commentators alike largely agreeing that a more balanced approach to investment protection was necessary, the search for a more suitable paradigm was underway.

B. *The General Theory*

Critics of the investor rights approach believe that tribunals go astray by failing to appreciate the significance of the fact that one side of the dispute is a sovereign state acting in its regulatory capacity.[73] In the past, when investment disputes more typically involved expropriations or other conduct that directly targeted the investor, the parties could be treated as equals, with no special concern for the needs of the state.[74] But the investment disputes confronting tribunals increasingly involve challenges to generally applicable regulations designed to promote the public interest and only indirectly affecting the value of foreign investment.[75] Such disputes need to be addressed not as "reciprocal disputes between private parties" but instead as "*regulatory* disputes between individuals and the state."[76]

Recognizing the vertical nature of the relationship between the disputing parties opens the door to a shift from private to public law principles. The foundational premise of the latter view is that when a state exercises its police powers to regulate in the public interest, such actions are generally within its discretion as sovereign and subject to only limited constraints.[77] In the domestic context, those constraints come from administrative or constitutional law, which may impose certain procedural requirements on the government or protect against interference with certain fundamental individual rights. But the state otherwise has broad authority to balance burdens and benefits across society, so in policing those limits, courts must be careful not to substitute their judgment for that of the political branches, which have greater competence and

72. *Saluka Investments*, *supra* note 11, ¶ 300.

73. *See* William W. Burke-White & Andreas von Staden, *Private Litigation in a Public Law Sphere: The Standard of Review in Investor-State Arbitrations*, 35 YALE J. INT'L L. 283, 285 (2010).

74. *See id*. at 289 (quoting Cai Congyan, *China-US BIT Negotiations and the Future of Investment Treaty Regime: A Grand Bilateral Bargain with Multilateral Implications*, 12 J. INT'L ECON. L. 457, 477 (2009)).

75. *See id*.

76. VAN HARTEN, *supra* note 10, at 4.

77. *See* Choudhury, *supra* note 7, at 777.

legitimacy to make policy in the public interest.[78]

Proponents of the public law approach contend that a similar framework should be applied to the international investment law context. Like administrative and constitutional law on the domestic side, international investment law imposes "restraints on a state's exercise of powers vis-à-vis private investors."[79] When investors invoke those limits to challenge a state's regulatory acts, investment tribunals should not treat the two parties as equals, but instead must proceed with special care for the concerns of the state as sovereign.[80] Proponents of the public law approach have borrowed a number of different tools from domestic sources to implement that general principle. I consider two such efforts in the following two Sections.

C. *Proportionality*

Consistent with the public law perspective, the proportionality approach rejects the primacy of investment protection and instead treats investor rights as something to be balanced against other public policy concerns.[81] It recognizes that sovereign states must regulate in ways that negatively affect some individuals or groups, and such regulations should not be deemed impermissible unless the burdens imposed are disproportionate to the benefits gained.

Proportionality falls within the more general category of balancing tests, which are a commonly used tool in public law contexts. As Professors Alec Stone Sweet and Florian Grisel explain:

> Proportionality is an analytical framework first developed by administrative and constitutional courts in order to manage legal disputes of a particular structure, the paradigmatic example of which concerns a pleaded tension between a right on the one hand, and a constitutionally recognized public interest pursued by the State, on the other.[82]

Investment tribunals borrowed the proportionality test more specifically from the human rights context, and in particular from decisions by the European Court of Human Rights (ECtHR).[83] The analogy was easiest to see with human rights claims involving the deprivation of property. Citing the ECtHR's formulation in *James v. United Kingdom*,[84] the first investment tribunal to import proportionality did so to evaluate a claim of expropriation,

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78. *See* Roberts, *supra* note 26, at 67.

79. Stephan W. Schill, *International Investment Law and Comparative Public Law—An Introduction*, *in* INTERNATIONAL INVESTMENT LAW AND COMPARATIVE PUBLIC LAW 3, 17 (Stephan W. Schill ed., 2010).

80. *See* Roberts, *supra* note 26, at 67.

81. *See id*. at 66.

82. Alec Stone Sweet & Florian Grisel, *Transnational Investment Arbitration: From Delegation to Constitutionalization?*, *in* HUMAN RIGHTS IN INTERNATIONAL INVESTMENT LAW AND ARBITRATION, *supra* note 52, at 118, 131.

83. *Tecmed*, *supra* note 57, ¶ 122.

84. James v. U.K., App. No. 8793/79, ser. A, no. 98, Eur. Ct. H.R. (1986). The court there stated, "[n]ot only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim 'in the public interest,' but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realized." *Id*. ¶ 50.

stating "[t]here must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure."[85]

Later tribunals then further adapted that principle to the issue of fair and equitable treatment. In *Saluka Investments*, the tribunal first emphasized the sovereignty concerns at stake in a nod to the public law perspective:

> No investor may reasonably request that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well.[86]

The tribunal then formulated its proportionality test as follows: "The determination of a breach of Article 3.1 by the Czech Republic therefore requires a weighing of the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate regulatory interests on the other."[87]

Prominent commentators have endorsed the approach of the tribunal in *Saluka Investments*. For example, Professors Benedict Kingsbury and Stephan Schill argue that a proportionality approach may be particularly attractive to those who believe that international investment law unduly promotes investment protection at the expense of other concerns, because it allows for a broader range of considerations to be taken into account.[88] They also argue that a proportionality approach has the potential to discipline the reasoning of tribunals and, by improving the quality of their decision-making, enhance their legitimacy.[89] Stone Sweet and Grisel similarly argue that the adoption of a proportionality test "would inject a measure of analytic, or procedural, determinacy to the balancing exercise."[90]

Yet it is precisely with regard to administrability and legitimacy that I contend the proportionality approach falls short. To see why my assessment differs from these others, it is important to bear in mind the baseline they are using. Regarding administrability, Kingsbury and Schill argue that a proportionality approach constitutes an improvement over "'I-know-it-when-I-see-it'-type of reasoning."[91] Thus, they conclude, "[a] proportionality analysis certainly seems preferable as a rational process for balancing investment protection and competing interests, by comparison with approaches in which an extensive summary of the facts of the case at hand is followed by [an] abrupt determination with little intelligible reasoning . . . ."[92]

Analyzing facts within a proportionality framework is of course

85. *Tecmed*, *supra* note 57, ¶ 122.
86. *Saluka Investments*, *supra* note 11, ¶ 305.
87. *Id*. ¶ 306.
88. Kingsbury & Schill, *supra* note 56, at 51-52.
89. *See id*.
90. Stone Sweet & Grisel, *supra* note 82, at 131.
91. Kingsbury & Schill, *supra* note 56, at 51.
92. *Id*.

preferable to making abrupt conclusions without supporting reasoning. Such a framework would at least point tribunals to the relevant considerations. But once each side of the equation is determined, the proponents of proportionality provide no guidance regarding how interests that are so different in kind should be valued and weighed against each other. Indeed, while there may be extreme cases of disproportionality on which the majority of decision-makers could agree, the basic act of balancing is a fundamentally indeterminate exercise.[93] To illustrate the point, consider how a tribunal should evaluate Philip Morris's claim against Uruguay discussed above. It is difficult to see, from the standpoint of law, how the financial losses incurred by Philip Morris can be meaningfully weighed against the public health benefits to be gained by stronger health warnings.

It is true, of course, that domestic courts regularly engage in such balancing in a variety of contexts to review the legality of government action.[94] But when they do, it is understood that such decisions are not purely legal but involve at least a degree of policy judgment.[95] As explained by one proponent of proportionality, Professor Aharon Barak, the act of balancing "requires a common denominator," such as "the social importance of the conflicting principles at the point of conflict."[96] Other proponents recognize the concern about judicial policymaking, but believe the advantages of proportionality outweigh the disadvantages.[97] Barak further contends that this form of judicial review is entirely consistent with a constitutional democracy and presents no legitimacy concerns, at least when carried out by domestic courts.[98]

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93. *See* Alec Stone Sweet, *Investor-State Arbitration: Proportionality's New Frontier*, 4 L. & ETHICS HUM. RTS. 47, 50 (2010). The incommensurability problem should not, of course, be overstated. As one commentator puts it, "[t]he objection from incommensurability is significant, and yet there is no denying that judgments made under the rubric of proportionality may reflect shared intuitions about justice, and to that extent may seem unobjectionable." Grant Huscroft, *Proportionality and Pretense*, 29 CONST. COMMENT. 229, 243-44 (2014) (reviewing AHARON BARAK, PROPORTIONALITY: CONSTITUTIONAL RIGHTS AND THEIR LIMITATIONS (2012)).

94. For example, courts evaluating statutes under the Equal Protection Clause balance the individual's right to be free from discrimination against the government's interest in drawing the distinction at issue, applying different tiers of scrutiny depending on the nature of the classification being drawn. *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES § 9.1.2, at 685-86 (4th ed. 2011). Likewise, courts evaluating claims of Fourth Amendment violations balance the individual's right to privacy against the government's interest in conducting the search at issue. *See, e.g.*, United States v. Knights, 534 U.S. 112, 118-19 (2001) ("The touchstone of the Fourth Amendment is reasonableness, and the reasonableness of a search is determined 'by assessing, on the one hand, the degree to which it intrudes upon an individual's privacy and, on the other, the degree to which it is needed for the promotion of legitimate governmental interests.'" (quoting Wyoming v. Houghton, 526 U.S. 295, 300 (1999))).

95. *See, e.g.*, Molly S. McUsic, *Looking Inside Out: Institutional Analysis and the Problem of Takings*, 92 NW. U. L. REV. 591, 660 (1998) (noting that the ad hoc balancing test applied in U.S. takings cases "obviously requires policy judgments").

96. Aharon Barak, *On Society, Law, and Judging*, 47 TULSA L. REV. 297, 310 (2011).

97. *See* Alec Stone Sweet & Jud Mathews, *Proportionality Balancing and Global Constitutionalism*, 47 COLUM. J. TRANSNAT'L L. 72, 87 (2008) (noting that "balancing can never be dissociated from lawmaking: it requires judges to behave as legislators do, or to sit in judgment of a prior act of balancing by elected officials"); *see also* Kingsbury & Schill, *supra* note 56, at 51-52 ("Proportionality analysis . . . is open to the criticisms that it confers power on judges to take policy-driven decisions about the proper balance between conflicting rights and interests.").

98. BARAK, *supra* note 93, at 253.

Advocates of judicial restraint may be uncomfortable with even domestic judges exercising such lawmaking power, but for present purposes the more significant concern is that international arbitrators are particularly ill-equipped to do so. First, the backgrounds of investment arbitrators are relatively homogeneous and typically do not include any public law expertise.[99] Second, various limitations on arbitration procedures make the process less optimally structured than most courts (which are already less optimally structured than legislatures) to receive the relevant inputs needed to make good decisions.[100] And third, foreign arbitrators lack the legitimacy to exercise policymaking authority because they are (in part) privately appointed and not accountable to the domestic public that their decisions affect.[101] As one commentator put this last point: "most troubling[] is that the system's unique use of private arbitration in the regulatory sphere conflicts with cherished principles of judicial accountability and independence in democratic societies; in effect, it taints the integrity of the legal system by contracting out the judicial function in public law."[102]

All three of those problems can theoretically be fixed, or at least mitigated, through reforms. But there is another dimension on which international arbitrators will never have the relevant expertise to review state decisions or the legitimacy to exercise that power. As Professors William Burke-White and Andreas von Staden explain, one reason we are comfortable with domestic judges exercising some degree of lawmaking authority is that they "are embedded within the social, political and legal environment within which they operate."[103] That close connection is important because, as Barak writes, a judge applying proportionality is required

> . . . to look at the legal system as a whole. He has to consider the constitution and the role the different principles play in it. He has to read the legal system's history and the jurispruden[ce] of the courts. The judge attempts to express the basic values of the society in which he lives.[104]

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99. *See* Burke-White & von Staden, *supra* note 73, at 330; Roberts, *supra* note 26, at 77; *see also* Choudhury, *supra* note 7, at 831 (noting that, in practice, "even where a tribunal weighs a public interest against interference with an investment, the impact upon investment, rather than the gravity of the public interest issue implicated, is the key consideration in determining whether an investment obligation has been violated").

100. *See* Choudhury, *supra* note 7, at 785-89.

101. *See id*. at 818-21. While it is true that states, through treaties, make the initial delegation of authority to international investment tribunals to decide disputes, that one-time act is seen as too thin to create legitimacy given the length of the commitment and the absence of ongoing supervision. *See* Kingsbury & Schill, *supra* note 56, at 54; *see also* VAN HARTEN, *supra* note 10, at 25 (noting that a state's general consent to investment arbitration potentially creates "a type of governing arrangement" and "raises special concerns about the delegation of adjudicative authority to arbitrators who are insulated from domestic judicial review").

102. *See* VAN HARTEN, *supra* note 10, at 4. There is also the question of the broader legitimacy of the system: because tribunals cite each other's decisions as precedent, even when different treaties are at issue, individual arbitrators who were formally appointed to decide only one dispute can have a much broader impact on state and investor conduct around the world. *See* Kingsbury & Schill, *supra* note 56, at 6-7; *see also* Roberts, *supra* note 37, at 190-91 (arguing that tribunals are not accountable to the states that are creating them because they rely on the precedent of other tribunals).

103. *See* Burke-White & von Staden, *supra* note 73, at 331.

104. *See* Barak, *supra* note 96, at 310.

International arbitrators will likely never be sufficiently versed in the needs and concerns of the individual states whose decisions they review to perform those tasks adequately. Given this lack of perspective, we should be skeptical about allowing arbitrators to make sensitive policy determinations that are likely to turn on context-specific judgments.[105] In short, a more administrable test that tribunals can apply legitimately is needed.

D. *Deferential Approaches*

For those who are otherwise sympathetic to the public law perspective, the primary alternative to proportionality is a form of review that affords greater deference to state decision-making. Proponents of a deferential approach start from the same place—a recognition that sovereign states have discretion "to allocate burdens and benefits across society"[106] through regulation—but conclude that tests like proportionality allow tribunals to interfere too much with that discretion. They propose instead that a state's balancing determination be respected in the absence of some extreme deficiency.

Commentators have suggested a variety of doctrinal tests to implement that general principle. One suggests applying a standard similar to the "arbitrary and capricious" standard under the Administrative Procedure Act.[107] Others propose borrowing the margin of appreciation doctrine applied by the ECtHR,[108] and some tribunals have actually done so.[109] Another tribunal, echoing the language of U.S. courts applying rational basis review, emphasized in an ICSID arbitration against Hungary that its "task here is not to sit retrospectively in judgment upon Hungary's discretionary exercise of a sovereign power, not made irrationally and not exercised in bad faith toward Dunamenti at the relevant time."[110] Absent such concerns, tribunals should afford states considerable latitude to regulate as they see fit.

An initial critique of these deferential approaches is that they do not solve the problem of legitimacy. To a certain extent, deferential approaches do reduce administrability concerns because they allow tribunals to resolve any close cases in favor of the state. But they nonetheless reserve some authority for tribunals to find violations based on policy judgments. Applying a deferential approach still requires tribunals to draw boundaries of permissible action that are not based on any legal determination.[111] Thus, while a deferential approach reduces the policy discretion held by the reviewing

105. *See* Burke-White & von Staden, *supra* note 73, at 336.

106. SANTIAGO MONTT, STATE LIABILITY IN INVESTMENT TREATY ARBITRATION 7 (2009).

107. *See* Katselas, *supra* note 13, at 91.

108. *See* Burke-White & von Staden, *supra* note 73, at 304-05.

109. *See* Julian Arato, *The Margin of Appreciation in International Investment Law*, 54 VA. J. INT'L L. 545, 551 (2014).

110. Electralabel S.A. v. Hungary, ICSID Case No. ARB/07/19, Decision on Jurisdiction, Applicable Law and Liability, ¶ 8.35 (Nov. 30, 2012).

111. In a related critique, Professor Julian Arato shows how tribunals invoking the margin of appreciation have in fact applied very different forms or levels of deference when doing so. *See* Arato, *supra* note 109, at 564-65.

tribunals, it does not change the essential nature of their task and so leaves them vulnerable to the legitimacy critique.

Moreover, to the extent proponents of a deferential approach have justified it by analogy to domestic public law, their argument rests on shaky premises. In their view, the fair and equitable treatment guarantee is equivalent to the obligation of democratic states to make decisions consistent with the rule of law.[112] But the more limited obligation of a democratic state to its own nationals is based on the fact that the latter yield some of their autonomy in exchange for the state's protection and other benefits of citizenship.[113] Foreign investors do not enter the state via the same implicit bargain. Instead, they enter as beneficiaries of an agreement—the BIT—by which the host state has voluntarily yielded some of its sovereignty.[114] Thus, the discretion that host states have to regulate to the detriment of foreign investors should arguably be reduced. At the same time, foreigners may be in need of greater protection because they cannot participate as directly in the election of officials and the formulation of the policies they enact.[115] In light of these differences in status between the foreign investor and the state's nationals, the limited protections provided to the latter do not justify interpreting BITs to grant foreign investors nothing more than "protections from abuses of governmental power."[116]

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In sum, both the proportionality test and the deferential approach would require some degree of policymaking and thus prevent tribunals from producing principled judgments or otherwise improving on their legitimacy concerns. And both approaches, like the public law framework generally, ignore the possibility of further inquiry into the contracting states' intent. The next Part shows how a contractual approach would be an improvement in all these respects.

III. A CONTRACTUAL APPROACH

This Part begins by explaining why a contractual approach is superior to existing solutions from a functional standpoint. By using open-ended terms like fair and equitable treatment in their BITs, states delegated authority to investment tribunals to develop the meaning of such standards through application to specific cases. States have not instructed tribunals to use a contractual approach any more than they have mandated a public law framework. The argument here is simply that tribunals should look to contract

112. *See* Katselas, *supra* note 13, at 91, 149.

113. *See* Anita L. Allen, *Social Contract Theory in American Case Law*, 51 FLA. L. REV. 1, 2 (1999) ("Social contract theories provide that rational individuals will agree by contract, compact or covenant to give up the condition of unregulated freedom in exchange for the security of a civil society governed by a just, binding rule of law.").

114. *See* Kassi D. Tallent, *The Tractor in the Jungle: Why Investment Arbitration Tribunals Should Reject a Margin of Appreciation Doctrine*, *in* 3 INVESTMENT TREATY ARBITRATION AND INTERNATIONAL LAW 111, 129-30 (Ian A. Laird & Todd J. Weiler eds., 2010).

115. *See id*. at 130 (noting that "the investor is an outsider to the democratic processes influencing the development and application of state regulatory measures").

116. Katselas, *supra* note 13, at 148 (emphasis omitted).

law and theory because it offers tools that will assist them in developing a more principled approach to regulatory disputes as well as in enhancing their legitimacy.

After Section III.A lays out the functional argument, the remaining Sections in this Part adapt specific tools from contract law and theory to show how tribunals could better respect the contracting states' intent. The first of these, a default rule approach, approximates the parties' intent by identifying the term that most states would have adopted if they had considered the matter. A default rule approach has the particular advantage of providing clear, advance notice of how tribunals will resolve disputes and thereby placing the onus on states to revise the term if the default approach does not comport with their preferences.

The second and third principles both come from contract law's attempt to deal with the problem of changed circumstances. The two proposed approaches, a foreseeability test and efficient risk bearer analysis, are alternative ways that courts and scholars have identified to fill the gap when the contracting parties fail to address a particular supervening event. Instead of providing the certain but inflexible answer that a default rule approach would, the foreseeability and efficient risk bearer approaches serve as default standards that allow adjudicators to take into account additional contextual facts in attempting to resolve the dispute as the parties would have wanted.[117] Although the two tests sometimes point in different directions, both rest on plausible assumptions about the unstated intentions of parties to a contract, and with some tinkering both can provide a principled framework for resolving regulatory disputes in a manner that plausibly approximates the contracting states' intent. The final Section in this Part explains how one might choose among the three proposed tools and how the chosen solution could be implemented.

One potential objection worth addressing at the outset is the possibility that states have implicitly endorsed the public law framework by continuing to create BITs with an unqualified fair and equitable treatment standard. That inference is not warranted for two reasons. First, although I have described a gradually forming scholarly consensus around the public law framework, there is sufficient variance in tribunal practice to preclude an inference that states are implicitly endorsing any particular approach. Second, as discussed further below, states have in fact expressed their dissatisfaction with the status quo by revising more recent BITs in various ways. Thus, the available evidence suggests that states are in fact looking for a better approach to fair and equitable treatment. The proposals here, although primarily designed for tribunals to use as gap-filling measures, are also available options for these dissatisfied states to incorporate explicitly into their BITs.

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117. Although the term "default rule" is often used to mean "default provision" without regard to how precisely the provision is tailored, the literature does recognize a distinction between default rules and default standards. For a discussion of the tradeoff between these two approaches, see generally Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1 (1994).

A. *The Functional Argument*

The basic proposition that treaties should be interpreted according to the parties' intent is uncontroversial.[118] In any treaty regime, no one would dispute that such intent, when reflected in clear text, should be respected.[119] Likewise, courts and tribunals are seeking to determine the parties' intent when they interpret a treaty's terms "in their context and in the light of its object and purpose," as the Vienna Convention on the Law of Treaties dictates.[120] The difficult question arises when interpretation by text and purpose do not resolve the issue, and some other mechanism is needed to resolve the ambiguity. That of course is the case here, as text and purpose do not resolve how the fair and equitable treatment guarantee should apply to regulatory disputes.

Contract theory has developed a number of tools to approximate the parties' intent in the face of ambiguity. Notably, although scholars have applied contract theory to other international law questions,[121] relatively little has been said about how its interpretive aids, beyond text and purpose, could be applied to construe treaties. One commentator has explored how certain interpretive canons, such as the presumption against the drafting party, could be adapted to the treaty context.[122] Others have argued that the tools of a particular scholarly perspective, known as relational contract theory, provide a useful resource for common treaty interpretation problems.[123] In the international investment law context specifically, tribunals and commentators have not taken advantage of contract law's more sophisticated tools of interpretation.

To be precise, I should acknowledge that critics of the investor rights approach have occasionally equated it to a private law or contract law paradigm. For example, Burke-White and von Staden criticize tribunals for "operat[ing] as if the only rights at stake were those of investors and as if [they] were enforcing narrowly drawn private law contracts divorced from public law

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118. A broader debate exists over whether treaties are more like statutes or contracts or should be understood as *sui generis*. *See* Alex Glashausser, *What We Must Never Forget When It Is a* Treaty *We Are Expounding*, 73 U. CIN. L. REV. 1243, 1267-68 (2005) (summarizing and citing examples of all three perspectives). But even those who do not find the contract analogy to be the best fitting one would not disagree with the limited proposition set forth above. *See id*. at 1299 ("[M]ost commentators agree that the touchstone of treaty interpretation is the intent of the parties."). Nor would they likely disagree that there is value in borrowing tools from a variety of sources, given the hybrid nature of treaties. *See id*. at 1247-48 ("Treaties undeniably have much in common with statutes and contracts, and that commonality is a useful starting point."). My argument here is only that there is untapped promise in further developing the contract analogy in this particular context, and not that it should trump all other sources for treaty interpretation matters generally.

119. *See, e.g.*, Sumitomo Shoji Am., Inc. v. Avagliano, 457 U.S. 176, 180 (1982) ("The clear import of treaty language controls unless 'application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories.'" (quoting Maximov v. United States, 373 U.S. 49, 54 (1963))).

120. Vienna Convention on the Law of Treaties art. 31, May 23, 1969, 1155 U.N.T.S. 331, *reprinted in* 8 I.L.M. 679 (entered into force Jan. 27, 1980) [hereinafter Vienna Convention].

121. *See supra* note 18.

122. *See* Glashausser, *supra* note 118, at 1308-21.

123. *See* Curtis J. Mahoney, Note, *Treaties as Contracts: Textualism, Contract Theory, and the Interpretation of Treaties*, 116 YALE L.J. 824, 846-56 (2007); Jared Wessel, Note, *Relational Contract Theory and Treaty Interpretation: End-Game Treaties v. Dynamic Obligations*, 60 N.Y.U. ANN. SURV. AM. L. 149, 149-50 (2004).

context."[124] For them, a private law approach means unduly favoring investor rights while overlooking the sovereignty concerns at stake. Their critique therefore does not bear on the contract analogy developed here, focusing on the two states as the contracting parties rather than on the investor and host state as the disputing parties.[125] Furthermore, I do not disagree with the critique that such scholars have made of the investor rights approach and I am not advocating a return to the narrow view of investment treaties that ignores values other than investment protection. Instead, I am suggesting that contract theory offers more resources for the present challenge—including tools that can adequately protect state sovereignty—than has previously been recognized. These tools have not yet been examined in practice or in scholarly commentary.

As a further caveat, I should emphasize that in analyzing the intent of the contracting states, I am looking primarily at constructed rather than actual intent. When there is sufficient evidence of actual intent, that intent will trump the default gap-filling principles proposed here, and as described below, the adoption of clearer defaults may in fact spur the parties to address the gaps that currently exist. But in the absence of a discernible actual intent, the task here, as in contract law, is to construct what the parties likely would have wanted based on a hypothetical bargain. And the hypothetical bargain analysis is an intent-driven inquiry because it focuses on the purposes the parties sought to achieve rather than simply filling in gaps with whatever the adjudicator believes would be the optimal provision.[126]

Before turning to the proposed tools and their respective strengths and weaknesses in the next two Sections, I begin with a more general argument for why a contractual approach is functionally superior to the public law framework. The basic argument is that a contractual approach properly focuses the tribunal's inquiry on an issue that the tribunal is better equipped and has the legitimacy to resolve. With respect to administrability, there are some differences among the particular tools that I will address below, but the general point is that an inquiry into intent relies on legal concepts that do not require the weighing of incommensurable values. Indeed, the intent inquiry is designed to largely avoid examining the substance of the policy at all. Accordingly, tribunals would be able to decide regulatory disputes based on legal principle rather than policy discretion.

With respect to legitimacy, that value would follow to some extent from

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124. Burke-White & von Staden, *supra* note 73, at 297; *see also* Stephan W. Schill, *Multilateralizing Investment Treaties Through Most-Favored Nation Clauses*, 27 BERKELEY J. INT'L L. 496, 560 (2009) ("BITs are not ordinary contracts between private parties, but international treaties to be interpreted according to rules and rationales that differ from those in the interpretation and application of commercial contracts.").

125. Professor Anthea Roberts refers to this as the paradigm of public international law, as distinguished from both private law and public law. Roberts, *supra* note 26, at 62-63. Roberts also notes the unique challenges arising from the fact that the parties involved in the dispute are different from the ones that made the agreement. *Id*. at 59-61.

126. *See* David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1831-32 (1991) ("To construct the hypothetical bargain, then, one should ask what stipulated term makes sense of the parties' project, as the parties themselves understand it?").

more principled reasoning alone. But there is another important respect in which a contractual analysis would reduce legitimacy concerns: by allowing tribunals to act more as agents seeking to effectuate the intent of the states as principals and less as trustees exercising their own independent judgment.[127] As explained above, the concern with the proportionality test is that international arbitrators lack the legitimacy to exercise the policymaking authority the test requires. And even the deferential approach, while giving states wide latitude to regulate as they see fit, ultimately requires tribunals to draw boundaries that are grounded in policy judgments, however modest. By contrast, a contractual approach would not require a tribunal to independently assess the validity of the host state's regulatory acts. Instead, it would evaluate those acts as part of an effort to enforce the limits that the parties themselves prescribed.

The preceding analysis of legitimacy also helps to address the concern raised by proponents of the public law approach that a private law framework fails to adequately account for state sovereignty concerns. That objection is compelling when a tribunal treats investors and states as equal in status and thereby overlooks the latter's prerogative to regulate in the public interest.[128] But the objection has less force when tribunals merely seek to enforce a valid agreement between two co-equal states to limit their own regulatory capacities. Enforcing the agreement is in that sense a way to respect rather than restrict their sovereignty.

Finally, I would note that the general idea of shifting control or influence from the tribunals and back to the states is one that others have endorsed. For example, Professor Jason Yackee argues that states should reassert their interpretive authority by creating BITs with additional control mechanisms that would enable the states to veto or otherwise influence tribunal decisions.[129] Likewise, Professor Anthea Roberts argues that tribunals should pay greater attention to the preferences of treaty parties as expressed through subsequent practice or interpretive agreements.[130] Those suggestions are consistent with the proposals made here and share a common concern that the states have taken a backseat to tribunals in the proper interpretation of investment treaties. The primary difference is that Yackee and Roberts focus on institution-level reforms or otherwise urge the states themselves to take on a greater role in interpreting their BITs. I offer suggestions on what the tribunals can do more immediately to better respect states' intent and potentially to spur them to speak more clearly.[131]

127. This is not to suggest that there is no sense in which tribunals should act as trustees, only that the public law approach would push them too far in that direction. For a general discussion of when tribunals should perform one or the other roles, see Karen J. Alter, *Agents or Trustees? International Courts in Their Political Context*, 14 EUR. J. INT'L REL. 33, 39-40 (2008).

128. *See* Burke-White & von Staden, *supra* note 73, at 297.

129. *See* Jason Webb Yackee, *Controlling the International Investment Law Agency*, 53 HARV. INT'L L.J. 391, 434-45 (2012).

130. *See* Roberts, *supra* note 37, at 179.

131. That is not to say that the tools proposed here must necessarily be interim. As I discuss in Section III.D below, they could also be made permanent either through codification in particular BITs or if adopted by tribunals through a process of common law development.

B. *A Default Rule Approach*

In contract law, when courts confront a gap in the agreement, they often fall back on default rules to resolve the dispute. For example, under the Uniform Commercial Code (UCC), if the parties fail to specify a place of delivery, the default is the seller's place of business.[132] The term is a default one because the parties can override it by specifying a different one. The primary benefit of a default rule is that it yields a clear answer, which makes it both more easily administrable for the courts and more predictable for the parties to plan around. The alternative would be to conduct a more standards-driven inquiry into the circumstances surrounding the transaction to make the best possible estimate of the parties' intent.[133] The primary tradeoff between the two approaches is that standards facilitate ex post accuracy while rules promote ex ante clarity.[134]

The potential benefits of the default rule approach are readily apparent in the context of investor-state regulatory disputes. A rule-based approach would be the easiest possible test for tribunals to administer. Moreover, predictability would seem to be particularly valuable to the contracting states and third-party-beneficiary investors given the stakes involved. Because of the costs and resources associated with enacting regulations and investing in a foreign country, all parties involved would likely appreciate being able to plan without the uncertainty of how a future tribunal will determine their rights and obligations. There is a plausible argument, therefore, that the need for ex ante clarity outweighs the value that potentially more accurate ex post analysis would offer.[135]

The conventional way to identify the appropriate default rule is the majoritarian approach, which instructs courts to choose the term "that the majority of parties would agree upon if negotiating and drafting a relevant provision were cost-free."[136] The rationale behind this approach is that it increases efficiency by enabling most parties to rest on the default term and avoid the transaction costs of formally incorporating it into their agreement.[137] In the present context, the proper majoritarian default rule would likely be one that resolves regulatory disputes in the host state's favor. It bears emphasizing that this rule would not preclude investors from invoking fair and equitable treatment to challenge other concerns, including bad faith, lack of due process,

132. U.C.C. § 2-308 (2002).

133. *See* George S. Geis, *Economics as Context for Contract Law*, 75 U. CHI. L. REV. 569, 590-91 (2008) (reviewing VICTOR GOLDBERG, FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE (2006)).

134. *See id*.

135. *Cf.* Sanders, *supra* note 24, at 344 (arguing against the use of the multi-factor *Penn Central* test for indirect expropriation claims because foreign investors need the certainty of a clear rule to determine where to invest). As I explain in Section III.D below, I do not ultimately take a position on whether the default rule approach is superior to one of the proposed default standards but I am merely trying to highlight the relevant tradeoffs.

136. Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 613-14 (1998).

137. *Id*. at 614.

and harassing or coercive conduct by state officials.[138] But to the extent an investor bases its claim solely on a departure from regulatory stability, the majoritarian default rule would hold this claim to be outside the scope of the fair and equitable treatment guarantee.

A few reasons support the conclusion that most states would prefer a general rule resolving regulatory disputes in favor of host states. The first is that states generally stand to lose a great deal more if found liable as host states in a regulatory dispute than what they stand to gain as home states from an investor's successful claim. The former not only is experienced much more directly, but also presents the risk of a catastrophically high award of damages.[139] The force of this point is diminished somewhat by the fact that capital investments do not flow equally both ways. But the trends in this regard are changing. Although traditionally investment flowed to developing nations from developed ones, increasing levels of investment are flowing in the opposite direction, and even developed states now must respond to claims brought by foreign investors.[140] As a result of such shifts, the United States, to give one example, has revised its model BIT to place more limitations on investor rights despite the fact that it is a significant exporter of capital and would stand to benefit from strong investor protections.[141]

Moreover, even states that are predominantly capital-exporting have an important reason to prefer that the burden of harm fall on the investor rather than the host states, at least as a general rule. That reason stems from the analysis above recognizing that investment treaties are designed to promote long-term economic cooperation and not to require investment protection at all costs. The states themselves, and not only commentators and tribunals, have recognized this point and are acting accordingly in more recent BITs.[142] Because even predominantly capital-exporting states should be more interested in long-term cooperation than in ensuring protection for any one investor, they should be concerned about overly constraining the regulatory flexibility of their partner states, which may then be inclined to exit the international investment regime, as some have already attempted to do.[143] Thus, while individual states in particular circumstances may opt to go a different route, the proper majoritarian default for BITs in general would be one that permits states to enact good-faith regulations in the public interest without being subject to

138. *See* Knoll-Tudor, *supra* note 52, at 322-35.

139. For example, Joshua Simmons cites eight examples of investors obtaining awards over one hundred million dollars. Joshua B. Simmons, *Valuation in Investor-State Arbitration: Toward a More Exact Science*, 30 BERKELEY J. INT'L L. 196, 196 n.2 (2012). Although Simmons does not distinguish among different types of treaty violations, at least a few of the cited examples involved violations of the fair and equitable treatment obligation.

140. *See* Roberts, *supra* note 37, at 196.

141. *Id*. at 197 n.84.

142. *See* Roberts, *supra* note 26, at 80 ("[A]n increasing number of investment treaties are including provisions in their preambles that make clear that investment promotion and protection are not to be achieved at the expense of other key values, such as protection of health, safety, labor standards, and the environment.").

143. *See* Roberts, *supra* note 37, at 191-92 (noting that a few states have withdrawn from the ICSID Convention and more may do so if the regime evolves in an unfavorable direction).

liability under the fair and equitable treatment standard.

Although the adoption of a majoritarian default rule is designed to approximate the parties' intent (as well as any general rule could), it is important to emphasize that this is not meant to be the end of the conversation. One of the values of the rule-based approach is that it puts the parties involved on clear notice of how the tribunal will interpret the term at issue.[144] If the adopted interpretation does not comport with the preferences of particular states, they are free to codify the opposite view or—more likely in this setting—to revise the rule to be less absolute. But whether they do so or not, the use of a clear rule allows tribunals to shift the responsibility for the term's meaning to the contracting states themselves and thereby reduce concerns about the legitimacy of their decisions.[145]

As an illustration, consider the Philip Morris–Uruguay dispute described in the introduction of this Article. To establish a violation of fair and equitable treatment, Philip Morris could not merely claim that the regulations altered the legal framework in a way that diminished Philip Morris's investments. Philip Morris would instead have to show bad faith, meaning that Uruguay acted not to achieve legitimate policy objectives but rather to extort profits from the company or to achieve some political gain at the company's expense.[146] No allegations in this vein are present. Philip Morris's claim under fair and equitable treatment is simply that the adopted "measures frustrate one of the most fundamental expectations that any investor may have, which is that a host State will comply with its own law and respect private property."[147] Under the default rule proposed here, Philip Morris's fair and equitable claim would fail in the absence of new facts suggesting bad faith on the part of Uruguay.

There is an alternative approach to selecting defaults that is likely inappropriate for the present context but worth briefly considering. This approach, known as the penalty default, involves supplying a term that is actually contrary to the parties' likely preferences to create an incentive for the parties to specify their intent more clearly.[148] As relevant here, penalty defaults are justified when one of the parties has more knowledge but prefers to keep the contract strategically incomplete to avoid disclosing its superior information.[149] As Professors Ian Ayres and Robert Gertner explain, "[o]ne

144. *See* Geis, *supra* note 133, at 590-91.

145. *Cf.* Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 827 (1992) ("Under certain circumstances, it is not at all fictitious to characterize a choice to remain silent and let default rules operate as an expression of consent . . . . And, even when parties cannot be said to have consented by their silence to the enforcement of particular default rules, enforcement may still be justified on the grounds of consent when default rules are chosen to reflect the commonsense or conventional understanding of most parties.").

146. *See generally* Deyan Draguiev, *Bad Faith Conduct of States in Violation of the 'Fair and Equitable Treatment' Standard in International Investment Law and Arbitration*, 5 J. INT'L DISP. SETTLEMENT 273, 284-85 (2014).

147. *See* Philip Morris, Request for Arbitration, *supra* note 1, ¶ 84. The argument that Uruguay failed to "comply with its own law" is that the measures adopted by the Ministry of Public Health exceed what was contemplated in the legislation passed by the Uruguayan parliament. *See id.* ¶¶ 20-24.

148. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

149. *See id.* at 94. The other rationale is to incentivize parties to disclose information to courts.

party might strategically withhold information that would increase the total gains from contracting (the 'size of the pie') in order to increase her private share of the gains from contracting (her 'share of the pie')."[150] A penalty default rule seeks to disincentivize such strategic withholding and thereby facilitate the creation of the more socially optimal bargain.

The penalty default approach has some initial appeal in the present context. Tribunals could adopt the opposite of the majoritarian default term and require states to pay compensation for harm whenever their good-faith regulations substantially decreased the value of a foreign investment. As a result, most states would be incentivized to revise the default term, thereby revealing information about their regulatory plans to their counterparts and to the third-party-beneficiary investors, who could then make better decisions about where to invest. Although any default rule has this information-forcing effect,[151] the incentive is weaker under a majoritarian default regime because states might be more willing to live with its rough approximation of their preferences and say nothing more.

Despite the benefits of increasing information disclosure, a penalty default approach may not be justified if the value of that revealed information is outweighed by the increased costs of contracting around the default.[152] More importantly for this particular context, given the already serious concerns about their legitimacy, it is difficult to imagine tribunals expressly choosing to "penalize" states with a term that contradicts their likely preferences and deciding cases against them while they scramble to revise the default. Thus, whatever theoretical appeal a penalty default approach may hold, it is not likely as a practical matter to be implemented by tribunals.

Returning to the majoritarian default discussion, recent practice suggests that changes in response to tribunal interpretations are more than a theoretical possibility. For example, states have begun to expand the exceptions provisions in their BITs in response to concerns about their regulatory flexibility. States have included such provisions in some form in their BITs for as long as BITs have existed.[153] A typical provision would state that "[t]his treaty shall not preclude the application by either Party of any and all measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace and security, or the

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Id. at 97. But that justification exists primarily to prevent parties from shifting costs "to a subsidized judicial system." *Id*. at 99. The rationale therefore does not make sense in the context of investor-state arbitration, which is not paid for by anyone other than the disputing parties.

150. *Id*.

151. *See* Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563, 573 (2006) ("A majoritarian rule is information-forcing because the minority types will contract out of it if transaction costs are low enough, revealing both their valuations and the valuations of the majority that does not opt out. The only difference between the two rules is that more parties opt out of—or would prefer to opt out of—a penalty default rule than out of a majoritarian default rule, everything else held equal.").

152. *See* Ayres & Gertner, *supra* note 148, at 128.

153. *See* William W. Burke-White & Andreas von Staden, *Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures in Bilateral Investment Treaties*, 48 VA. J. INT'L L. 307, 326-27 (2008).

protection of its own essential security interests."[154] More recent treaties, however, have gone a step beyond security concerns to exempt measures designed to protect public health.[155] If the proposed majoritarian default term does not align with their preferences, contracting states could continue down this road of drafting more detailed provisions about what types of measures should and should not be subject to challenge under the fair and equitable treatment standard.

In a similar vein, a recent study by the United Nations Conference on Trade and Development (UNCTAD) catalogued the ways in which states have used "reservations" to specify particular industries for which they are reserving their regulatory flexibility.[156] Such provisions differ from exceptions clauses in that the latter focus on the purpose of the regulation at issue and potentially span multiple sectors.[157] The reservations discussed in the UNCTAD study, by contrast, specify that regulations in certain areas, like agricultural and transportation services, will be exempt from the investment treaty's substantive protections.[158] Another distinguishing feature of reservations is that they need not be mutual: each state can identify the particular areas they want to exclude.[159] To date, reservations have primarily been adopted in relation to an investment treaty's "liberalization commitments" as opposed to its "[p]rotection obligations."[160] The former include provisions like the national treatment principle, requiring a host state to treat foreigners the same as its own nationals, while the latter include more absolute rules such as the prohibition on expropriation without compensation.[161] Although the UNCTAD study does not discuss fair and equitable treatment specifically, at least the stability component of that guarantee would not seem to be absolute and thus should be a permissible subject for reservation.

While states have begun adapting the language of new BITs, there is less evidence that they have gone back to alter existing BITs. Given the time and resources required for states to amend treaties,[162] there is a concern that the adoption of a default term would effectively be the last word for all existing BITs. Commentators have suggested other ways, however, in which contracting states could make their intent clearer. If an investor's home state expresses

154. *Id.* at 327 (quoting Treaty Concerning the Treatment and Protection of Investments, U.S.-Pan., art. X(1), Oct. 27, 1982, 21 I.L.M. 1227).

155. *See* Barnali Choudhury, *Exception Provisions as a Gateway to Incorporating Human Rights Issues into International Investment Agreements*, 49 COLUM. J. TRANSNAT'L L. 670, 688-89 (2011) (citing examples).

156. U.N. Conference on Trade and Dev., *Preserving Flexibility in IIAs: The Use of Reservations*, U.N. Doc. UNCTAD/ITE/IIT/2005/8 (2006).

157. *See id.* at 7.

158. *See id.* at 64; *see also id.* at 24-25 (describing in greater detail the variety of ways in which reservations can specify exempted measures). In principle, exceptions clauses need not be mutual either, as each contracting state could bargain for different exclusions based on its own needs. But to my knowledge existing BITs have not included such asymmetrical exceptions clauses.

159. *See id.* at 21-22.

160. *See id.* at 66 n.13.

161. *See id.*

162. *See, e.g.*, Kingsbury & Schill, *supra* note 56, at 51 ("[I]n the investment treaty context, the revision of BITs is a slow and slow-acting process requiring consent of both contracting State parties.").

agreement with the host state's position in the course of an investment dispute, tribunals could decide to credit that shared interpretation.[163] Likewise, if the two states adopt an interpretive agreement to memorialize their understanding of a term like the fair and equitable treatment guarantee, that may be sufficient to establish the meaning of that term for purposes of the BIT at issue.[164] Nothing in my proposal here requires states to use a formal amendment process to override the default interpretation. And while tribunals have expressed some reluctance to rely on views expressed in these other forms, they should be more willing to do so if they impose a default rule approach on states given that one goal of this approach is to elicit further dialogue.

Two additional concerns warrant further consideration. The first is that this approach is unfair to investors that may have committed to foreign ventures in reliance on the protections of a fair and equitable treatment guarantee. Particularly since that guarantee has been interpreted to require some degree of stability, this objection does have force with respect to investments that are already in place. But from a long-term perspective, the broader community of investors will benefit even from a default rule that is unfavorable to them because clarity will facilitate better planning. And as noted above, just because the default is initially set against investors does not mean that some states will not revise that rule in a way that gives investors more protection, along with greater certainty than they currently possess.

A second point worth acknowledging is that the majoritarian default rule proposed here would serve as a weaker check on state conduct than even the deferential approaches I discussed above. But as I explained in that discussion, the problem with the deferential approaches was not that they provided a weak check, but that they did so based on an unpersuasive analogy to domestic public law. The default rule approach, by contrast, is justified as an approximation of the contracting states' intent and by the goal of eliciting further clarification from the states themselves.

C. *Two Default Standards*

A default rule approach is by necessity a crude approximation of what the states themselves would want. A default standards approach, by contrast, would seek to produce a more accurate estimate of states' intent with respect to a particular case while sacrificing the predictability of a rule-based approach. It does so by identifying factors, based on plausible assumptions about state preferences, to guide the tribunal's analysis rather than providing a one-size-fits-all solution. This Section proposes two alternative default standards derived from attempts in contract theory to address a similar problem of ambiguous intent. Like a default rule, these standards are meant to fill a gap in the meaning of fair and equitable treatment as applied to regulatory disputes, but they can be overridden if the states so choose.

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163. *See* Roberts, *supra* note 37, 217-20.
164. *See id*. at 215-17.

To begin calibrating the appropriate default standard, it is necessary to identify the relevant state interests at stake. As noted above, it is increasingly common for investment to flow in both directions under a given BIT, and in any event both sides share an interest in long-term economic cooperation. These are reasons why, as outlined in the prior Section, states would not want investment protection to be absolute. But the objective of long-term economic cooperation also counsels against allowing host states too much regulatory flexibility, which the proposed majoritarian default would potentially provide. Specifically, the concern about maximizing regulatory flexibility at the expense of investment protection is that it may discourage some foreign firms from investing at all. Such an outcome would fail to satisfy the goal of economic cooperation, disappointing the expectations of capital importers and capital exporters alike. Thus, maximizing regulatory flexibility might be the best available general rule for purposes of setting a majoritarian default, but a proper default standard should strike a better balance between the competing objectives of investment protection and regulatory flexibility.

Contract law addresses a similar problem in the context of changed circumstances. The problem of changed circumstances arises when some risk not allocated in the contract materializes and dramatically alters the bargain the parties originally struck. As a general rule, contract law allocates to the promisor the risk that her performance will be made more burdensome in light of a supervening, post-formation event.[165] But the law also recognizes that in some instances changed circumstances will justify excusing the promisor's nonperformance. While the risks of a supervening event can always be allocated by agreement, contract theory offers two alternative tests for assessing when the promisor's obligation should be discharged in the absence of such a provision.

The present problem can likewise be understood as a concern about changed circumstances, with a minor adjustment.[166] While the contract law question is whether changed circumstances permit a promisor to excuse nonperformance, the question here is whether changed circumstances permit a host state to revise its regulatory framework without implicating its fair and equitable treatment obligation. But the basic objective in applying a default standard is the same in both contexts: to determine whether the changed circumstances at issue were of the sort that the parties themselves would have deemed legally significant.

To be clear, the goal of adapting these principles from contract theory is to give meaning to the vague concept of fair and equitable treatment and understand how it should apply to good-faith regulations that incidentally harm

165. *See* E. ALLAN FARNSWORTH, CONTRACTS § 9.6, at 625 (4th ed. 2004).

166. Beyond the general concept of changed circumstances, it would not be helpful to analogize to the more specific doctrines of impracticability and frustration of purpose. *See id*. § 9.6, at 624-33 (describing impracticability); *id*. § 9.7, at 634-40 (describing frustration of purpose). In revising its regulatory framework to address changed circumstances, the host state has not been forced to do anything impracticable, nor has its purpose in entering the BIT been negated. As emphasized in the main text, the goal of the analogy here is to think more generally about how changed circumstances might inform the concept of fair and equitable treatment.

foreign investment. By examining how contract law principles from the excuse context may shed light on that question, I am not suggesting that we approach the issue as one of excuse as such. Indeed, it would be assuming the conclusion to say that all good-faith regulatory changes are violations of the fair and equitable treatment guarantee and thus require the state to rely on an excuse defense. My purpose in adapting these contract theory concepts is instead to help determine whether the contracting states would likely have deemed such conduct to be violations of fair and equitable treatment in the first place.[167]

The distinction just drawn also explains why it would not make sense to incorporate contract law's high bar requiring an extraordinary change in circumstances.[168] Of course, for the tests to make sense there must be something in the world that the state can point to as a changed circumstance. If the state is addressing a problem that predated the BIT and truly has no new facets, its argument would be a nonstarter. But the bar for changed circumstances in the present context should otherwise be a low one. The high bar in contract law is based on the presumption that a promisor bears the ordinary risks of obstacles to its performance and should not be able to so readily resort to excuse. But that presumption does not apply in the present context because, as explained above, the purpose of the tests would be to determine whether the fair and equitable treatment obligation has been violated at all, not whether an excuse is permitted.

A final caveat to emphasize is that the proposed tests do not contemplate that the tribunals would evaluate the substance of the policies being challenged. After determining whether the supervening event satisfied the chosen test, the tribunal would not go on to evaluate whether the host state's response to that event was necessary or justified. The latter inquiry would raise the same concerns I identified in the public law framework, with tribunals being asked to independently assess the validity of a state's policy. It might be necessary for the tribunal to screen for pretext so that states do not point to changed circumstances that have nothing to do with the new regulation. But beyond that threshold inquiry the substance of the policy would not be examined.

With that background, the following two Subsections discuss the two alternative approaches that contract theory has developed to address changed circumstances and adapt them to the problem of regulatory disputes.

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167. Most investment treaties do provide for a type of excuse defense, which is known as necessity. *See, e.g.*, Choudhury, *supra* note 7, at 805-06 (describing how tribunals analyzed Argentina's necessity defense based on a severe economic crisis). I will not discuss necessity at length here, except to note that there is some potential overlap with the proposed changed circumstances analysis: once a tribunal determines that the fair and equitable treatment obligation has been violated, the same facts that were relevant to liability may again be relevant under the necessity analysis.

168. What must be extraordinary is the degree to which performance has been rendered impracticable or, in the case of frustration of purpose, the extent to which the value of the performance to the promisee has been negated. *See* FARNSWORTH, *supra* note 165, § 9.6, at 627-28; *id*. § 9.7, at 636. Translating that high bar to the present context would mean that the state would have to be able to point to a genuine crisis requiring a drastic response, as opposed to merely new developments in society.

1. *Foreseeability*

A central factor in analyzing the significance of changed circumstances is whether the supervening event was foreseeable. The Restatement (Second) of Contracts does not specifically mention foreseeability, but instead says that the nonoccurrence of the supervening event must have been "a basic assumption on which the contract was made."[169] However, as the comments to the Restatement explain, the fact that an event "was not reasonably foreseeable when the contract was made" would support a conclusion that the nonoccurrence of that event was in fact a basic assumption.[170] The UCC commentary likewise explains that the excuse defense is not available "when the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks which are fairly to be regarded as part of the dickered terms."[171]

The underlying premise of the foreseeability test is that if the supervening event invoked to support the promisor's defense was sufficiently within the parties' contemplation, then it makes sense to treat the promisor as having assumed the risk of that event's occurrence.[172] That is because the promisor had an opportunity to bargain to place a condition on her performance based on that risk. If the agreement is silent on the issue, courts may infer from the parties' silence that they did not intend to alter the general rule that the risk of burdened performance falls on the promisor.[173] The promisor is thus presumed to have priced the potential downside consequences into the agreement.[174] If, however, the supervening event was not foreseeable, then that inference no longer holds, as the parties could not be presumed to have priced the risk into the bargain they struck. Thus, rather than allocating the risk to the promisor, courts find an

169. RESTATEMENT (SECOND) OF CONTRACTS §§ 261, 265 (1979).

170. *Id*. § 261 cmt. c (1979).

171. U.C.C. § 2-615 cmt. 8 (2012). It is also worth noting that the Vienna Convention on the Law of Treaties includes foreseeability as a factor in the changed circumstances analysis. *See* Vienna Convention, *supra* note 120, art. 62(1) (providing that "[a] fundamental change in circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties," may permit a party to terminate or withdraw from a treaty under certain conditions). I do not suggest that investment tribunals rely directly on the Vienna Convention because the relevant provision applies when a state seeks to terminate or withdraw from a treaty or suspend its operation based on changed circumstances. In seeking to enact a regulation without having to compensate burdened foreign investors, a host state would generally not be looking to take any of those more drastic steps with regard to the investment treaty as a whole.

172. *See* FARNSWORTH, *supra* note 165, § 9.6, at 631.

173. Justice Traynor of the California Supreme Court explained the issue as follows:

> The purpose of a contract is to place the risks of performance upon the promisor, and the relation of the parties, terms of the contract, and circumstances surrounding its formation must be examined to determine whether it can be fairly inferred that the risk of the event that has supervened to cause the alleged frustration was not reasonably foreseeable. If it was foreseeable there should have been provision for it in the contract, and the absence of such provision gives rise to the inference that the risk was assumed.

Lloyd v. Murphy, 153 P.2d 47, 50 (Cal. 1944).

174. *See* John Elofson, *The Dilemma of Changed Circumstances in Contract Law: An Economic Analysis of the Foreseeability and Superior Risk Bearer Tests*, 30 COLUM. J.L. & SOC. PROBS. 1, 4 (1996) (noting that "we can assume that the promisor has demanded and received a risk premium in return for assuming all the risks that he could reasonably have anticipated, and therefore that his obligations should not be discharged if one of those risks does in fact materialize").

implied condition in the agreement that the promisor's performance was contingent on the nonoccurrence of the supervening event.[175]

The same rationale makes foreseeability a plausible basis for deciding investor-state regulatory disputes. The underlying premise would be that contracting states wanted the fair and equitable treatment guarantee to encompass a commitment of regulatory stability as to foreseeable supervening events because each host state could price those risks into their agreement. At the same time, the contracting states would have wanted host states to retain flexibility to address unforeseeable changed circumstances and not have to compensate foreign investors for any lost value that new regulations caused.

Notably, an intuition along these lines is already lurking in the literature, as commentators often cite unforeseen events as a reason to disfavor interpreting the fair and equitable treatment guarantee to include a strong stability commitment. For example, Schill argues that "tribunals should allow for a certain flexibility for host states to react, for instance, to emergency situations."[176] Thus, there appears to be general agreement that a host state is most justified in changing the regulatory framework when it is responding to some unexpected supervening event. But from this indisputable premise that host states need flexibility to respond to emergency situations, Schill goes on to conclude that tribunals should always balance investor rights and sovereignty concerns without limiting the state's prerogative to such unforeseen events.[177] No justification is provided for making that leap. The proposal here would limit the host state's flexibility to the situations in which most agree flexibility is truly needed.

In practice, much depends on how high the threshold is set for what is considered unforeseeable. In contract law, many U.S. jurisdictions set a high threshold because courts are reluctant to find implied conditions on a promisor's performance. Under this view, for example, sharp price increases due to supply shortages would not be considered unforeseeable to the promisor.[178] Some more unusual event, outside the ordinary experience of the parties, is required. If investment tribunals adopted this view of foreseeability, then only extraordinary events, such as the outbreak of war or a natural disaster, would meet the threshold—and even then only if there were no warnings that those particular risks were brewing. Absent some external shock to the system, ordinary developments, such as economic downturns or environmental degradation, would be deemed to have been foreseeable.

175. *See* FARNSWORTH, *supra* note 165, § 9.5, at 623-24; *see also* Elofson, *supra* note 174, at 4 (noting that the occurrence of an unforeseeable event may "remove[] the situation from the scope of the parties' expectation").

176. Stephan W. Schill, *Fair and Equitable Treatment, the Rule of Law, and Comparative Public Law*, *in* INTERNATIONAL INVESTMENT LAW AND COMPARATIVE PUBLIC LAW, *supra* note 79, at 151, 165; *see also* Kingsbury & Schill, *supra* note 56, at 18 (noting that stability cannot be absolute because "a serious crisis or even an emergency situation may call for different reactions than the deployment of public power in the normal course of things").

177. *See* Schill, *supra* note 176, at 165-66.

178. *See* H. Ward Classen, *Judicial Intervention in Contractual Relationships Under the Uniform Commercial Code and Common Law*, 42 S.C. L. REV. 379, 386 (1991) (citing Maple Farms, Inc. v. City Sch. Dist., 352 N.Y.S.2d 784 (Sup. Ct. 1974)).

Some courts and commentators have expressed concerns about setting the bar too high. They do so out of recognition that even foreseeable risks may be too remote for the parties to want to spend time bargaining over their allocation.[179] One court has suggested that the question should instead be whether, "based on past experience, [the supervening event] was of such reasonable likelihood that the obligor . . . should have guarded against it or provided for non-liability against the risk."[180] Similarly, one commentator proposes that the analysis focus on whether there is information available at the time of formation to put the promisor on notice of the possibility of the supervening event.[181] Framing the test in this way has the advantage of allowing courts to focus on concrete evidence rather than having to speculate in the abstract about what the promisor should have anticipated.

If investment tribunals adopted something closer to this view of foreseeability, then a host state could address new problems that were not within its contemplation at the time the treaty was ratified without implicating the fair and equitable treatment guarantee. An external shock to the system would not be necessary; the problem could instead materialize, for example, as the result of an unexpected confluence of previously existing forces. Importantly, setting the bar at this level would still give investors a valid claim when a host state changes policy because a new government with different preferences took control. Likewise, under this version of the foreseeability test investors would have a valid claim when the state makes changes in response to a problem about which information had begun to emerge at the time of ratification. For example, a public health crisis that grew out of pollution concerns that were apparent at the time of ratification would be deemed foreseeable. By contrast, a public health crisis that grew out of a combination of population migrations and mutations in previously existing viruses would be deemed unforeseeable.

In the present context, the lower bar would likely be a better approximation of the contracting states' intent. In a typical private contract involving discrete and relatively well-defined obligations, it is reasonable to presume that the parties have priced in all but the most extremely remote contingencies into their agreement. But the fair and equitable treatment guarantee is far more expansive than any obligation a private party could enter into. Modern states are involved in regulating all spheres of life, and nearly all of those have the potential to affect foreign investment. When a state commits to regulatory stability as part of the fair and equitable treatment guarantee, everything that happens within its borders or otherwise falls within its jurisdiction is a potentially relevant risk. Thus, unlike parties to a private contract, states cannot realistically price even relatively proximate contingencies into their agreement. Given the vast scope and complexity of

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179. *See* FARNSWORTH, *supra* note 165, § 9.6, at 630-31.

180. *Id.* § 9.6, at 632 (quoting Opera Co. v. Wolf Trap Found., 817 F.2d 1094, 1103 (4th Cir. 1987)).

181. Stephen J. Sirianni, *The Developing Law of Commercial Impracticability and Impossibility: Part I*, 14 UCC L.J. 30, 61-62 (1981).

issues to which modern states need to respond, it is more likely that they intended their stability commitment to apply to regulatory concerns that are more directly within their contemplation at the time of ratification. Concerns outside that zone would not be foreseeable, and therefore any regulatory revisions undertaken in response to them would be outside the scope of the fair and equitable treatment guarantee.

As a further illustration, consider again the Philip Morris–Uruguay dispute. Under a foreseeability analysis, Philip Morris would likely have been able to show that Uruguay had adequate notice of the public health concerns surrounding smoking at the time the Uruguay-Switzerland BIT entered into force in 1991.[182] One can imagine closer cases involving contested questions about exactly when the available scientific evidence was sufficient to charge a host state with foreseeing the problem. But in the case of smoking, it would be difficult to deny that the evidence of its harms was well-established by 1991. Thus, applying a foreseeability analysis would likely result in an award in Philip Morris's favor.

Seeing this outcome may lead some to object that a foreseeability test places too much of a burden on states to anticipate their future regulatory agendas. Of course, states would prefer in the abstract to be free to adjust their regulatory frameworks based, for example, on new expertise or different policy goals. But each state has to balance that preference against the value it gains by making a meaningful stability commitment, namely attracting foreign investment and increased protection for its own investors operating in the counterpart state. A foreseeability line strikes a plausible compromise between these competing concerns.

Moreover, it should be reiterated that, as with default rules, states retain the ability to specify a different approach in their BITs. They could, for example, opt out of the foreseeability analysis entirely by declaring that their fair and equitable obligation does not extend to good-faith regulations in the public interest. They could also carve out particular limitations on their fair and equitable treatment obligation, as in the examples of the exceptions clauses described in the prior Section. It may not be realistic to do this on an issue-by-issue basis, creating exceptions for something as specific as cigarette marketing. But exceptions could be created at the categorical level. If a state's environmental or public health regulatory framework is underdeveloped and in need of revising, the state could negotiate for categorical exceptions to preserve flexibility in the needed areas while leaving the foreseeability test to serve as the line elsewhere. In this way, like a default rule approach, the foreseeability test can have the added benefit of encouraging the parties to specify their intent more clearly.[183]

A further objection to adopting the foreseeability analysis is that it is as

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182. *See* Philip Morris, Decision on Jurisdiction, *supra* note 3, ¶ 1.

183. *See* Elofson, *supra* note 174, at 38 ("In a jurisdiction in which the foreseeability test is consistently applied, promisors will learn to demand exculpatory clauses or risk premiums in return for facing foreseeable risks. . . . By adopting relatively clear rules of liability, [the law] can encourage parties to allocate these risks themselves, rather than forcing a court to do it for them after the fact.").

indeterminate as a proportionality test. Certainly in contrast to the default rule approach, a foreseeability test will not always yield clear answers. There is no denying that foreseeability is an open-ended standard, but it is one courts have been entrusted with applying in a range of legal contexts.[184] Many cases will be clear-cut, as when there is smoking-gun evidence that a host state had direct knowledge of a pending problem or, at the other end of the spectrum, when a supervening event occurs that is wholly without precedent. There will also be many close cases that require the exercise of judgment, but in drawing the appropriate line, tribunals would at least be charged with analyzing just the single value of foreseeability, rather than having to exercise the policymaking discretion required to balance incommensurable values.

2. *Efficient Risk Bearer Analysis*

Although foreseeability is the more commonly cited underlying principle, scholars using economic theory have suggested that the excuse doctrines are better explained as a question of which party is better positioned to bear the risk of a particular changed circumstance.[185] This conclusion follows from the general premise that contract law seeks to promote economic efficiency. Contracting parties are generally presumed to be seeking to maximize the value of their exchange. When their contract contains a gap, it should be filled with a term that best accomplishes that objective.[186] With respect to changed circumstances specifically, the gap should be filled by allocating the risk of a particular supervening event to the party better positioned to bear it.[187]

Generally the superior risk bearer is the party that could better insure against the event's occurrence.[188] To identify that party, courts consider which party could better evaluate the risk at issue (including the probability of the event's occurrence and the magnitude of loss should the event occur) and which could more cheaply purchase insurance or self-insure through diversification.[189] In a commonly cited example, the court in *Transatlantic Financing Corp. v. United States*[190] considered an excuse defense by a ship owner, which had entered into a shipping contract with the U.S. government, based on an international crisis that led to the closing of the Suez Canal and the blocking of the ship's intended route.[191] The court rejected the defense and

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184. To name just a couple, courts apply foreseeability as a limitation on damages for breach of contract, *see* RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979), and consider foreseeability at as many as three different points in a negligence analysis, *see* Benjamin C. Zipursky, *Foreseeability in Breach, Duty, and Proximate Cause*, 44 WAKE FOREST L. REV. 1247, 1249-55 (2009). For additional examples from family law, property law, and patent law, see Shyamkrishna Balganesh, *Foreseeability and Copyright Incentives*, 122 HARV. L. REV. 1569, 1598-1600 (2009).

185. *See* Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 90 (1977).

186. *See id*. at 88-89.

187. *See id*. at 90-91.

188. *See id*. at 90.

189. *See id*. at 90-92.

190. 363 F.2d 312 (D.C. Cir. 1966).

191. *See id*. at 314-15.

reasoned as follows:

> Transatlantic was no less able than the United States to purchase insurance to cover the contingency's occurrence. If anything, it is more reasonable to expect owner-operators of vessels to insure against the hazards of war. They are in the best position to calculate the cost of performance by alternative routes (and therefore to estimate the amount of insurance required), and are undoubtedly sensitive to international troubles which uniquely affect the demand for and cost of their services.[192]

In short, the court deemed Transatlantic to be the more efficient bearer of the risk that materialized.[193]

Adapting to the present context, the issue must be framed a little differently. The potential risk bearers are not the two contracting states, but rather the host state and investor as third-party beneficiary. Moreover, the host state cannot purchase insurance or self-insure in the sense of portfolio diversification in this context. Thus, there is no way to perform an apples-to-apples comparison to determine whether the host state or investor is the *superior* risk bearer.

Nonetheless, the efficiency framework provides a useful rubric for analyzing the ultimate issue in this context. Rather than attempting to compare the host state and investor, we can apply the same criteria of the difficulty of risk appraisal and feasibility of insurance to just the investor. The more difficult a risk was to assess and insure against, the less efficient it would be for the investor to have done so. As with the foreseeability test, the question of efficiency would be treated as a spectrum. Below a certain point on the spectrum, an investor would not have been expected to procure insurance and thus should be entitled to compensation from the host state. Above that point, the investor should expect to bear its own losses.

Like foreseeability, the principle of efficient risk bearing provides a plausible basis for distinguishing between changed circumstances that should permit a state to respond without implicating fair and equitable treatment and those that should not. While the contract law assumption that parties seek to maximize efficiency may not hold true for all the various forms of treaties states may sign, it seems reasonable to assume that parties to BITs in particular would take efficiency considerations seriously given their economic purpose. The default proposed here therefore attributes to contracting states an intent to compensate investors when they could not have efficiently insured against the risk of a particular regulatory development, while requiring investors to bear their own losses when such insurance could have been efficiently obtained.

192. *Id*. at 319.

193. Posner and Rosenfield endorse the court's reasoning as an illustration of superior risk bearer analysis. *See* Posner & Rosenfield, *supra* note 185, at 103-05. Other scholars argue that the court was wrong in its empirical assessment of which party could better appraise the risk, see*,* e.g., Melvin A. Eisenberg, *Impossibility, Impracticability, and Frustration*, 1 J. LEGAL ANALYSIS 207, 252 (2009), and criticize Posner and Rosenfield's broader theory as "virtually impossible to apply in practice," *id*. at 251. Even critics like Eisenberg, however, concede that insurance considerations may be relevant in some cases, such as when "there is a customary practice in a business sector to purchase . . . insurance" and insurance options are "readily available." *Id*. at 248.

A few general observations will help to illustrate how a default standard based on efficiency would apply to particular scenarios. First, with regard to risk appraisal, the investor would be better positioned to evaluate risks that relate more closely to its specific business. For example, an oil and gas company would typically have knowledge about the risks of environmental degradation and how a state's policy response is likely to affect its profit margins. Conversely, the same company is less likely to have any specialized knowledge about a state's regulatory agenda in intellectual property law or be in a good position to predict the harm any changes would pose to the company's value. Thus, a tribunal applying an efficient risk bearer analysis would be more likely to require the company to bear its own losses in the former scenario than in the latter.

Second, with regard to the possibility of insurance, an initial question would be whether market insurance for the relevant risk is available. For U.S. companies, a government agency called the Overseas Private Investment Corporation (OPIC) provides coverage for certain forms of regulatory risk, including "[m]aterial changes to feed-in tariffs" and "[r]evocations of licenses or permits necessary for the operation of a project."[194] It is unlikely, however, that OPIC would provide coverage for more general regulations that have a diffuse impact given the difficulty of assessing such risks. When market insurance is not available, the feasibility of self-insurance should be examined. In other words, could the company realistically have spread the risk of a particular form of loss by operating in different areas with distinct risk profiles? Factors in that analysis would include how large the company is, how diversified its business is, and whether other geographic locations are available to conduct the same sort of business.[195] The more readily a company could have obtained market insurance for or self-insured against the risk at issue, the more likely a tribunal would conclude that the investor should bear its own losses.

Consider the Philip Morris–Uruguay dispute as an illustration one last time. Because the marketing regulations relate directly to Philip Morris's core business, the company could reasonably be expected to have evaluated the risks of such developments and the impact they would have on its value. Moreover, Philip Morris could and indeed has self-insured against the risk of loss due to more aggressive public health regulations on smoking by operating in over 180 countries and ramping up specifically in developing states with weaker regulatory regimes.[196] Thus, applying an efficient risk bearer analysis would likely point to the conclusion that Philip Morris was well-positioned to bear the risk of the harm caused by Uruguay's regulatory changes and thus should lose

194. *Regulatory Risk*, OPIC, http://www.opic.gov/what-we-offer/political-risk-insurance/types-of-coverage/regulatory-risk (last visited Apr. 16, 2015).

195. *See* THOMAS J. MICELI, THE ECONOMIC APPROACH TO LAW 120 (2009) (noting such factors in assessing the feasibility of self-insurance).

196. *See* Trefis Team, *Philip Morris' Twin Strategies Keep It Smokin' Hot*, FORBES (Jan. 6, 2012, 7:59 AM), http://www.forbes.com/sites/greatspeculations/2012/01/06/philip-morris-twin-strategies-keep-it-smokin-hot; *Company Overview*, PHILIP MORRIS INT'L, http://www.pmi.com/eng/about_us/company_overview/pages/company_overview.aspx (last visited Apr. 16, 2015).

on its fair and equitable treatment claim.

As with foreseeability, one could object that the above analysis is as indeterminate as a proportionality test. The answer here is largely the same as above. Asking whether the investor could have efficiently insured against the risk does not require balancing incommensurable values, and efficiency in general is a concept courts are traditionally comfortable applying.[197] As with foreseeability, there will be many clear-cut cases. At one end of the spectrum, an extremely experienced investor with operations in numerous countries loses value following a regulation it has seen countless times before; at the opposite end, a small, novice investor loses value when the state revises general business rules unrelated to the investor's core expertise. Also, as with foreseeability, the fact that there will be borderline cases does not mean that the basic analysis is one that tribunals lack competence to apply.

A different sort of objection would point out that this analysis and foreseeability point in different directions, raising the question of how both could claim to approximate the contracting states' intent. Indeed, the two tests are roughly inverted versions of each other. Although the precise lines each test would draw are based on different criteria, in essence the foreseeability test places the burden on host states to plan for the risks of changed circumstances while the efficient risk bearer test places that burden on investors. But in suggesting that these tests could be used to approximate the contracting states' intent, the point is not that either one provides a definitive conclusion as to the actual intent of any particular parties. Rather, both tests provide a principled way to approach the issue and yield intuitively plausible approximations.

D. *Implementation*

The three tools just described are not meant to coexist as options for every individual arbitral panel to choose among on an ad hoc basis. As I have acknowledged, the tools would in some cases point to different results, potentially undermining the predictability that a shift to contract principles was intended to foster. Instead, I suggest that one of the proposed approaches be adopted wholesale.

This could be accomplished in one of two ways. One possibility alluded to above would be for states themselves to codify a particular tool in individual BITs. I noted earlier that some states have withdrawn from the international investment law regime entirely,[198] while others have incorporated language that narrows the meaning of fair and equitable treatment or carves out exceptions in their more recent BITs.[199] Future BITs could likewise codify one of the solutions proposed here as an alternative or in addition to those steps.[200] The

197. For example, the famous Hand formula for determining whether the standard of reasonable care has been breached involves a kind of efficiency calculation—namely, assessing whether the burden of adequate precautions was less than the product of the probability of harm and the magnitude of loss. *See* United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947).

198. *See supra* text accompanying notes 8, 143.

199. *See supra* text accompanying notes 54, 155-158.

200. For example, two contracting states might first decide that fair and equitable treatment

adopted test would then govern all disputes brought under the BIT at issue.

A second possibility would be for consensus to emerge around one of the tools as part of a process of common law development. As noted earlier, arbitral decisions are not binding on anyone other than the parties themselves, but there is nonetheless a norm of citing past decisions as persuasive precedent.[201] Just as some tribunals have begun employing proportionality reasoning, others may be persuaded to apply one of the contractual approaches proposed here, and over time a consensus may form regarding which one best reflects the states' intent.[202] That test would then serve as the default rule or standard for regulatory disputes, as always subject to override by contrary indications in particular BITs.

In arguing that tribunals should adopt a contractual approach, I have not taken a position as to which of the above proposals would be best. I believe all of them would be superior to the public law framework from the standpoints of encouraging principled reasoning and enhancing the legitimacy of the tribunals. Choosing among them would depend on additional normative questions I do not intend to take up here because doing so would require resolving deeply contested issues about the fundamental purpose of international investment law that have occupied much of the literature. My goal in highlighting potential tools from contract law and theory is instead to shift the existing discussion to the set of alternatives proposed here and to encourage the normative debates to continue in the context of choosing among them.

That said, I can briefly sketch a few of the relevant considerations. The first choice is whether to adopt a rule- or standards-based approach. As noted above, that choice depends on whether one believes that ex ante clarity is more important than ex post accuracy in the particular context of regulatory disputes.[203] A related question is how much one trusts the arbitrators who constitute investment tribunals to apply a standard as opposed to a rule. One should also weigh the importance of encouraging states to speak more clearly and consider which approach is more likely to produce that result.

If one concludes that a standards-based approach would be superior, the next question is whether to adopt a foreseeability or efficient risk bearer analysis. As alluded to earlier, the former test generally places a greater burden on states, while the latter generally places a greater burden on investors. As I

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should not apply at all to environmental and public health legislation, and thus create express exceptions so that any changes to the regulatory framework in those areas would not give rise to investor claims. They might then further decide that, for those regulatory areas to which the fair and equitable treatment obligation does apply, tribunals should evaluate claims under a foreseeability test rather than a proportionality analysis and define the standard accordingly.

201. *See supra* text accompanying note 45; *see also* Frédéric G. Sourgens, *Law's Laboratory: Developing International Law on Investment Protection as Common Law*, 34 NW. J. INT'L & BUS. 181, 185-86 (2014) (proposing that investment tribunals develop principles based on a common law approach).

202. I would also recognize the possibility that experimenting with a particular approach will reveal that it leads to undesirable results in real cases. Common law reasoning should be pragmatic, concerned primarily with whether a proposed approach effectively solves real-world problems rather than with its theoretical appeal. *See* Sourgens, *supra* note 201, at 185.

203. *See supra* text accompanying note 134.

have emphasized, both default standards attempt to reconcile the competing objectives of investment protection and regulatory flexibility, but they strike different balances between the two. Choosing between the foreseeability and efficient risk bearer analyses will therefore depend largely on which of the two objectives one believes merits greater concern.

Having identified those considerations, the important point to reiterate is that, whatever normative values one may prioritize, adopting the functionally superior contractual approach will put tribunals in a better position to pursue them in the long run.

CONCLUSION

International investment tribunals need a new approach to regulatory disputes, which will only grow in importance as foreign investors continue to expand their operations in the global economy and inevitably clash with host states seeking to regulate the complex problems of modern society. The public law framework was an improvement over the investor rights approach because the latter reflected a skewed understanding of the purpose of investment treaties. But the public law approach has its own flaws, requiring international arbitrators to engage in policymaking, a function that, in contrast to domestic judges, they lack the expertise and legitimacy to perform. A contractual approach allows tribunals to focus on the contracting states' intent rather than having to independently assess the validity of a host state's regulation. By reframing the inquiry in this way, tribunals can engage in more principled reasoning and reduce concerns about their legitimacy, and thereby ultimately better promote the goals of economic cooperation that international investment law was designed to achieve.