CHAPTER 1

The Rise of International Investment, Investment Agreements and Investment Disputes

*Karl P. Sauvant**

To set the scene and provide the context for this volume, I would like to make three points: (1) foreign direct investment (FDI) has become the most important vehicle to bring goods and services to foreign markets and to integrate national production systems; (2) this process has been accompanied by the rapid rise of international investment agreements (IIAs); and (3), most recently, we can also observe a substantial rise of international investment disputes.

The Rise of Foreign Direct Investment

Over the past 20 years, FDI[1] flows have expanded substantially, from around US$50 billion during the early 1980s, to US$1.3 trillion by the end of 2006; they are expected to stay roughly at this level during the next few years (Figure 1.1).

* Executive Director, Columbia Program on International Investment, and Co-Director, Millennium Cities Initiative. Email: karl.sauvant@law.columbia.edu. I would like to acknowledge with gratitude comments by Kenneth Vandevelde, Peter Muchlinski, Federico Ortino, and Luke Peterson, and the assistance by Michael O'Sullivan, Ted Platt and Hamed El-Kady.

1 FDI is defined as "an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)"; *see* UNCTAD, *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development* (United Nations Publication: 2007) [hereinafter UNCTAD 2007], p. 245. This general definition of FDI is based on OECD, *Detailed Benchmark Definition of Foreign Direct Investment*, 3rd Edition (OECD: 1996) and International Monetary Fund, *Balance of Payments Manual*, 5th Edition (IMF: 1993).

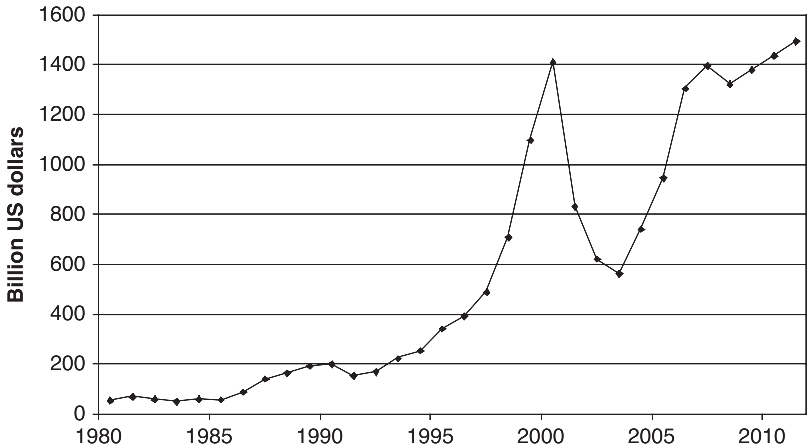

Figure 1.1 World inward FDI flows, 1980–2011 (Billion US dollars)
Source: UNCTAD (http://stats.unctad.org/fdi/) and Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk* (The Economist Intelligence Unit Ltd.: 2007).

The lion's share goes to developed countries, although developing ones (and especially Asia) account for a substantial amount: approximately 30% in 2006 (Figure 1.2).[2]

Most of these flows are in the services sector (some three-quarters) and originate in developed countries, although a rising share comes from emerging markets—some US$210 billion in 2006.[3]

This investment is undertaken by more than 80,000 parent firms controlling over 800,000 foreign affiliates (many of them having entered corporate systems through acquisitions). Increasingly, firms from emerging markets[4] are also becoming multinational corporations (MNCs)—firms that control assets abroad—as they are subject to the same pressures as their counterparts from developed countries. These include: (1) the liberalization of FDI regulatory frameworks throughout the world—which increases the opportunities for firms to expand abroad; (2) progress in, especially, information and communication technologies—which creates the means to run global production networks;

---

2 UNCTAD 2007.

3 Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk* (The Economist Intelligence Unit Ltd.: 2007).

4 Although emerging market MNCs, and some MNCs from economies in transition, have existed for some time, it is only recently that their activities have assumed important proportions. For a discussion of the issues to which this gives rise, *see* Karl P. Sauvant, with Kristin Mendoza and Irmak Ince, eds., *The Rise of Transnational Corporations from Emerging Markets: Threat or Opportunity?* (Edward Elgar: 2008).

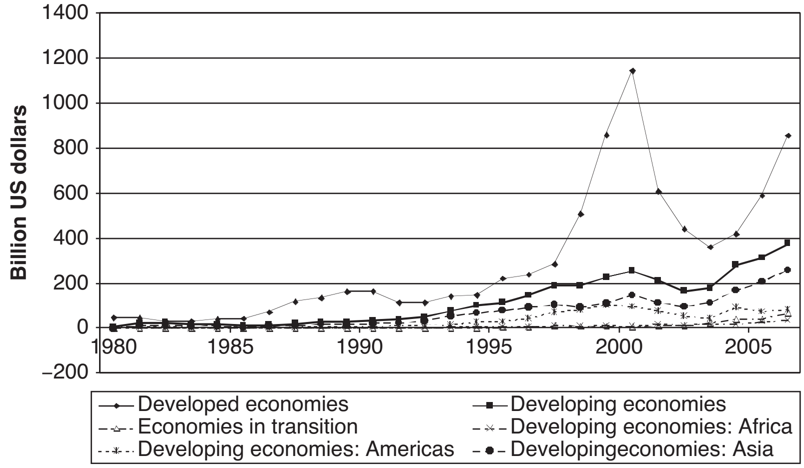

Figure 1.2 Inward FDI flows, by region, 1980–2006 (Billion US dollars)
Source: UNCTAD (http://stats.unctad.org/fdi/).

and (3) the pressures of competition—which lead firms to grasp these opportunities by undertaking outward FDI where the combination of ownership, locational and internalization advantages[5] makes this form of market entry superior to trade. Increasingly, indeed, any part of the production process can be located wherever it contributes most to a company's competitiveness, creating in this manner regional or global corporate production networks. In fact, foreign affiliates and such networks are more and more becoming a source of corporate competitiveness as they provide access not only to markets but also to various resources, ranging from natural resources and cheap labor to skills and technology. Hence the acquisition of a portfolio of locational assets becomes of key importance for firms, be they large or small, from developed countries or emerging markets.

The aggregation of these corporate networks is giving rise to an integrated international production system—the productive core of the globalizing world economy. Its importance can best be captured by looking at the accumulation of FDI flows, i.e., the stock of foreign direct investment. It stood at US$12 trillion in 2006 (Figure 1.3), roughly one-tenth of it accounted for by MNCs from emerging markets. (To this, one has to add various non-equity forms of control—such as management contracts and franchise agreements—through

[5] These are the main variables of the eclectic paradigm, the principal exploratory framework for FDI; *see* John H. Dunning, "The Eclectic Paradigm as an Envelope of Economic and Business Theories of MNE Activity," International Business Review, 9 (2000), pp. 163–192.

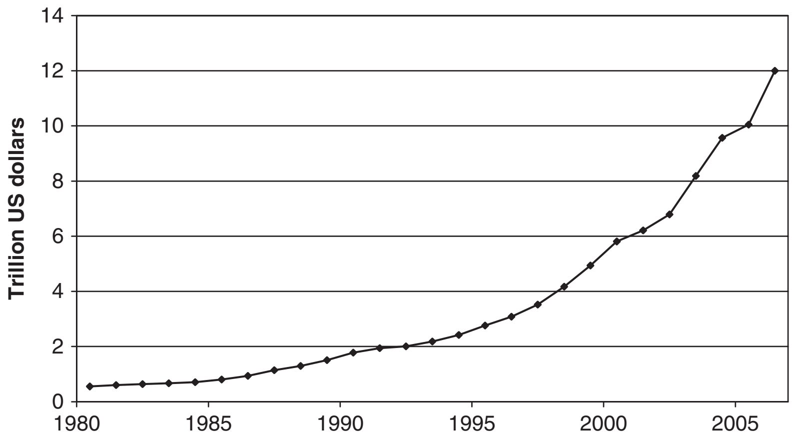

Figure 1.3 World inward FDI stock, 1980–2006 (Trillion US dollars)
Source: UNCTAD (http://stats.unctad.org/fdi/).

which additional economic activities are brought under the common governance of MNCs.) This FDI stock gave rise to an estimated US$25 trillion of sales by foreign affiliates (nearly twice the value of world exports in 2006), making FDI considerably more important than trade in terms of delivering goods and services to foreign markets, while, at the same time, integrating national production systems. In fact, roughly one-third of world trade takes place as intra-firm trade (i.e., trade among the various parts of the same corporate networks), and the bulk of technology is transferred within the framework of the integrated international production system. All of this means that FDI and the activities of MNCs have become central to the world economy, and to development.

The Rise of International Investment Agreements

No wonder, then, that all countries seek to attract FDI. For this purpose, the great majority of them have established investment promotion agencies (IPAs), in an increasing number of cases not only national ones but also sub-national ones. Their proliferation can best be seen from the growth of the World Association of Investment Promotion Agencies (WAIPA), which was established in 1995: by October 2007, it had 220 members (Figure 1.4).

Their role is to attract FDI, facilitate the establishment of foreign affiliates and provide after-investment services to those affiliates already established.

Perhaps even more impressively, all countries in the world have liberalized their FDI laws in an effort to attract more FDI, typically by opening more

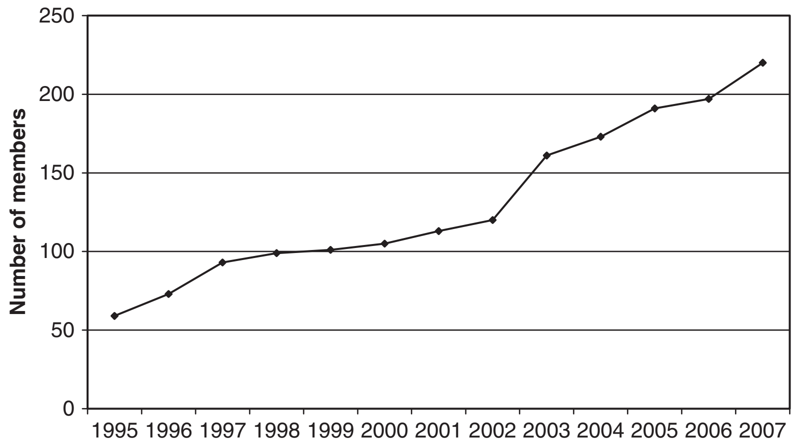

Figure 1.4 The growth of membership in WAIPA, cumulative, 1995–2007 (as of October 2007)
Source: WAIPA.

activities to foreign investors, reducing obstacles to the operation of foreign affiliates, providing a range of incentives, and offering various guarantees (for example, against nationalization) in their domestic laws, if not their constitutions. Of the 2,533 changes in FDI-related laws and regulations that took place between 1991 and 2006, some 90% were in the direction of making the investment climate more welcoming to FDI (Table 1.1). This is a pervasive trend, indeed.[6]

This trend is, furthermore, complemented by the rise of international investment law. Compared to the 1960s and 1970s, we have today a vastly different international investment law landscape. Back then, as Jeswald Salacuse writes in Chapter 6 of this volume, "foreign investors seeking the protection of international investment law found an ephemeral structure consisting largely of scattered treaty provisions, a few contested customs and some questionable general principles of law." Today, while no comprehensive multilateral investment treaty exists, international investment law is contained in a multifaceted, multilayered, increasingly complex network of international investment agreements (IIAs)—i.e., agreements that, in one way or another, address investment issues and involve virtually every country in the world.[7] Pride of place among these agreements belongs to bilateral investment treaties (BITs) for the promotion

---

6 There are however, signs of a backlash; *see* Karl P. Sauvant, "A Backlash Against Foreign Direct Investment?," *in* Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2010: Boom or Backlash?* (The Economist Intelligence Unit Ltd.: 2006), pp. 71–77.

7 *See* UNCTAD, *International Investment Arrangements: Trends and Emerging Issues* (United Nations Publication: 2006), for a discussion.

Table 1.1 National regulatory changes, 1991–2006

Item	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Number of countries that introduced regulatory changes in their investment regimes	35	43	57	49	64	65	76	60	63	69	71	70	82	102	93	93
Number of regulatory changes	82	77	100	110	112	114	150	145	139	150	207	246	242	270	205	184
More favorable to FDI[a/]	80	77	99	108	106	98	134	136	130	147	193	234	218	234	164	147
Less favorable to FDI[b/]	2	-	1	2	6	16	16	9	9	3	14	12	24	36	41	37

Source: UNCTAD, *World Investment Report 2005: Transnational Corporations and the Internationalization of R&D* (United Nations Publication: 2005, p. 26) and UNCTAD 2007, p. 14.

[a/] Includes further liberalization, or changes aimed at strengthening market functioning, as well as increased incentives.

[b/] Includes changes aimed at increasing control, as well as reducing incentives.

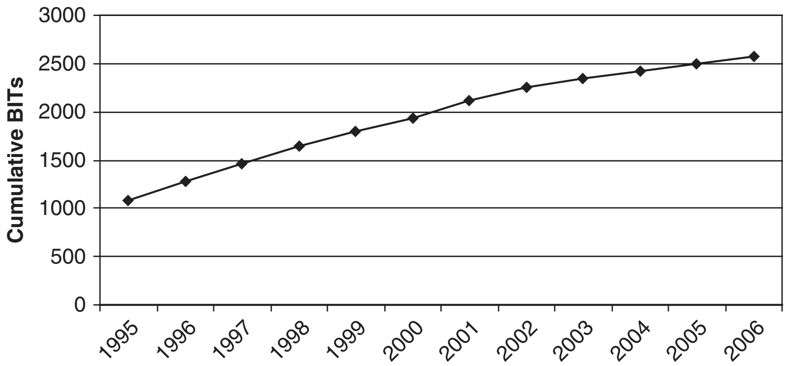

Figure 1.5 Number of BITs concluded, cumulative, 1995–2006
Source: UNCTAD (www.unctad.org/iia).

and protection of foreign investment. Their number had reached 2,573 at the end of 2006 (Figure 1.5), involving 179 countries. (*See* Appendices 6 and 7, *UNCTAD, IIA Monitors*.)

During 2006 alone, for example, 73 new BITs were concluded—more than one per week.[8] While early BITs were concluded primarily between developed and developing countries, their share of the stock of BITs had dropped to 40% by the end of 2006, while the share of BITs between developing countries had reached 27%.[9] Although the first BIT (between Germany and Pakistan) was concluded in 1959, BITs did not take off until the 1990s.[10] At that time, FDI flows became more important and countries, in their efforts to attract even more investment (and in the framework of overall more market-friendly policies), sought to signal the MNCs that they were prepared to guarantee an investment-friendly national regulatory framework through international agreements.

In addition to BITs, a number of other agreements also address investment matters, but as part of a range of other issues, most prominently among them

---

8 UNCTAD 2007. Unless otherwise indicated, the data used here come from this source. It should be noted that the number of BITs concluded per year has been decreasing since 2002, and a number of them are not (yet) in force (UNCTAD, "The Entry into Force of Bilateral Investment Treaties (BITs)," IIA Monitor, No. 3 (2006) (UNCTAD/WEB/ITE/IIA/2006/9)).

9 BITs between developed countries and countries of South-East Europe and the Commonwealth of Independent States accounted for 13%; between the latter group of countries and developing countries 10%; between developed countries 7%; and between countries of South-East Europe and the Commonwealth of Independent States 3%. *See* UNCTAD "Investment Instruments" on-line database (http://www.unctadxi.org/templates/Startpage___718.aspx).

10 There were fewer than 400 completed BITs in 1990.

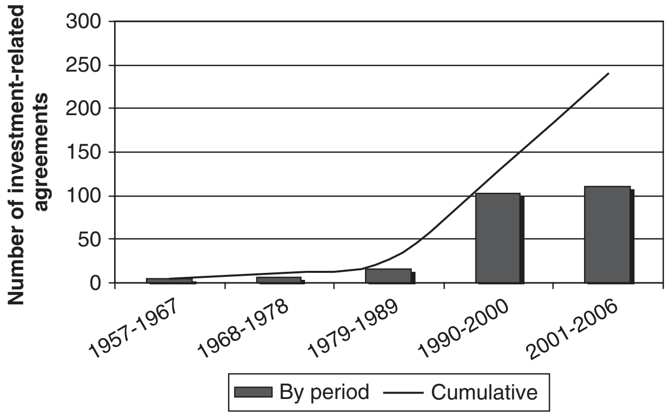

Figure 1.6 The growth of PTIAs, 1957–2006 (Number)
Source: UNCTAD 2007.

trade, but also *inter alia* intellectual property, competition and government procurement.[11] The number of such preferential trade and investment agreements (PTIAs) had reached 241 by the end of 2006, of which more than 90 involved developing countries only (Figure 1.6).

Developing countries participate in 79% of these PTIAs, compared to 54% for developed countries; as of end-2006, at least 72 additional agreements were under negotiation.[12]

These PTIAs represent an interesting development, in that they suggest a return to an earlier trend. Until the 1950s, investment matters were addressed (to the extent that they were covered at all) in comprehensive treaties akin to PTIAs; one example is the series of U.S. Friendship, Commerce and Navigation Treaties. Beginning in 1959, then, investment matters became the subject of separate treaties for the reasons mentioned earlier. BITs continue to be concluded, albeit at a decreasing rate, while investment matters are again being integrated into more comprehensive agreements, the PTIAs.[13] One of the

---

11 For a discussion of the rise of these agreements see OECD, "Novel Features in OECD Countries' Recent Investment Agreements: An Overview" (OECD: 2005), mimeo, reprinted in the annex of this volume. *See* also UNCTAD, *International Investment Arrangements: Trends and Emerging Issues* (United Nations Publication: 2006). Double taxation treaties (of which there were 2,651 by the end of 2006, *see* UNCTAD 2007, p. 16) are also important for MNCs; given their specialized nature, they are not discussed here.

12 UNCTAD 2007 and www.unctad.org/iia. For a full discussion of such agreements, *see* UNCTAD, *Investment Provisions in Economic Integration Agreements* (United Nations Publication: 2006).

13 This may also partly account for the decrease in the number of BITs concluded. However, the BITs in existence already cover most of the most important investment relationships, so it is only natural that the annual number of new treaties is declining. On the other hand, there are an increasing number of

reasons may well be that more comprehensive treaties allow more scope for trade-offs across issue areas.

Another reason may be that PTIAs typically are oriented more toward liberalization than BITs, i.e., they not only seek to protect investment that has already been made, but also tend to seek to reduce restrictions on investment. While it is true that some recent BITs also go beyond protection (e.g., those by the U.S., Canada and Japan that foresee national treatment at the entry stage), the overwhelming number remain focused on protection. In particular, they typically provide for national, most-favored-nation (MFN) and fair and equitable treatment; protection from expropriation (and rules for action if and when takings occur, including as regards compensation); and the transfer of funds. And, most importantly in the context of this volume, they typically contain provisions for investor-State dispute settlement.[14]

The Rise of International Investment Disputes

Foreign direct investment has not only become more important than trade, it is also more intrusive than (arm's length) trade, as it involves the entire range of issues related to the production process. This intrusiveness is accentuated by the fact that FDI not only has positive effects on host countries (e.g., it brings capital, technology, skills, access to markets), but can also have negative ones (e.g., it can lead to the crowding out of domestic firms or involve abusive transfer pricing, restrictive business practices or the control of sectors that, for one reason or another, are considered to be sensitive). Moreover, public policy and regulation concerning FDI take place in the context of several sets of tensions, both from the perspective of MNCs seeking a favorable investment climate and governments seeking to attract FDI and benefit from it as much as possible: the global corporate interests of MNCs vs. the national development interests of countries; foreign vs. domestic ownership; policies to attract FDI vs. policies to maximize its benefits; a country's interest as a host country vs. its interests as a home country; and the constraints imposed by the emerging integrated international production system, a globalizing world economy and international investment law vs. the need for policy space in the interest of national development. Combined with the rising number of IIAs containing

renegotiations of BITs; *see* UNCTAD, "International Investment Rule-Setting: Trends, Emerging Issues and Implications," TD/B/COM.2/73 (5 January 2007), mimeo.

14 For a full discussion of the contents of BITs, *see* UNCTAD, *Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking* (United Nations Publication: 2007).

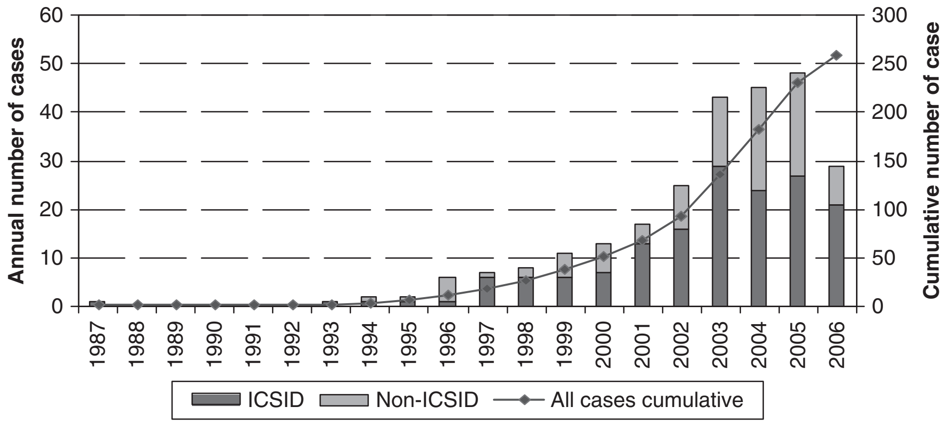

Figure 1.7 Known investment treaty arbitrations (cumulative and newly instituted cases, 1987–2006)
Source: UNCTAD 2007.

dispute settlement provisions and their growing complexity, all this makes it more likely that conflicts arise between foreign investors and host countries.

It is not known how many of such conflicts arise and are settled (amicably or otherwise) at the *national* level. What is a new and important development is that an increasing number of disputes are being brought to the *international* level, causing a veritable investment disputes explosion. (The reasons for this development are examined by Salacuse in Chapter 6.) More specifically, the number of known[15] treaty-based investor-State dispute settlement cases had reached 259 by the end of 2006 (Figure 1.7), virtually all of them initiated by investors.

The great majority of these cases (191 to be precise, or 74%) were filed since the beginning of 2002, with the currently highest number (50) filed in 2005.[16] For comparison: during the entire existence of GATT (1948–1994), a total of 101 disputes were brought, and another 369 disputes have been brought under the WTO from its inception through 25 September 2007.[17] It must be noted, however, that only States can use the WTO's dispute settlement machinery;

---

15 "Known" because the non-public nature of many disputes makes it likely that there are additional disputes not captured by the data reported here.

16 The data, here and below, are from UNCTAD, "Latest Developments in Investor-State Dispute Settlement," IIA Monitor, No. 4 (2006) (UNCTAD/WEB/ITE/IIA/2006/11) [hereinafter UNCTAD 2006], reprinted in the annex to this volume, and UNCTAD 2007. *See* UNCTAD 2006 for an instructive discussion of these disputes.

17 *See*: WTO "Chronological list of disputes cases." (http://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm).

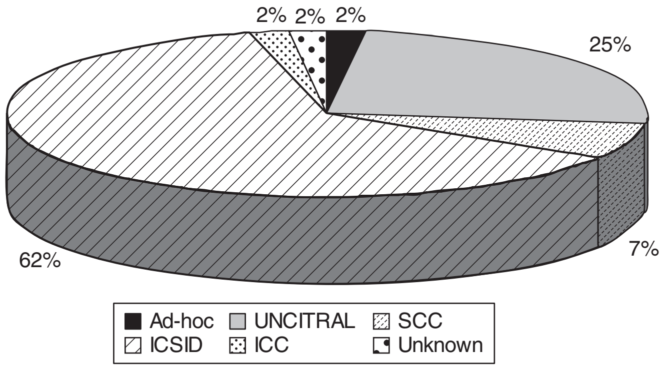

Figure 1.8 Disputes, by forum of arbitration, cumulative as of end-2006 (Percentage)
Source: UNCTAD 2007.
Note: SCC = Stockholm Chamber of Commerce; ICC = International Chamber of Commerce.

in the case of investment, on the other hand, and depending on the exact formulation of the applicable treaty, any of the 80,000-plus MNCs, 800,000-plus foreign affiliates and perhaps even their shareholders could potentially initiate a case.

Almost two-thirds of all known disputes have been brought before the International Centre for Settlement of Investment Disputes (ICSID) (or ICSID's Additional Facility), with the United Nations Commission on International Trade Law (UNCITRAL) providing the second most popular framework (Figure 1.8). The governments of 70 countries are involved, mostly of developing countries (44), but also of developed countries (14) and economies in transition (12) (Table 1.2). Argentina leads with 45 cases, all but three of them at least partly related to its recent financial crisis. Disputes have arisen

Table 1.2 Leading defendants in international investment disputes, as of end-2006

Defendant	*Number of claims*
Argentina	45
Mexico	18
Czech Republic	11
United States	11
India	9
Moldova, Republic of	9
Russia	9
Ecuador	8
Egypt	8
Canada	7
Poland	7
Romania	7

Source: UNCTAD (www.unctad.org/iia).

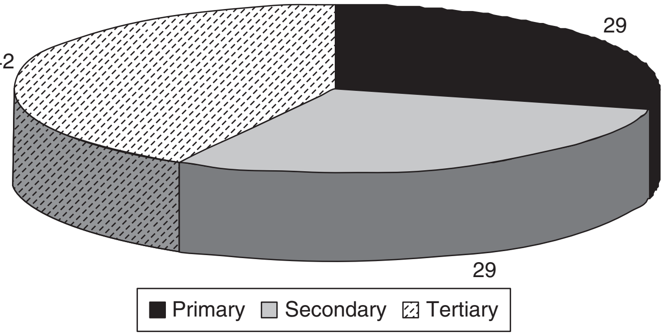

Figure 1.9 Sectors involved in known investment treaty arbitrations, as of end-2006 (Percentage)
Source: UNCTAD 2007.

roughly evenly in the services sector (including infrastructure), manufacturing and natural resources (Figure 1.9).

The issues that are or were involved in these disputes relate in particular to the interpretation of key elements of investment protection standards, especially as regards the principle of fair and equitable treatment, the international minimum standard of treatment, the scope of MFN treatment, and the meaning of "in like circumstances" as it relates to national treatment. Other issues include the question of regulatory takings, the scope of the umbrella clause, the notion of "effective control," and the definition of "investment," as well as, in relation to a number of cases involving Argentina, the question of whether a "state of necessity" existed, as a result of a national economic emergency, such as could excuse infringements of protection standards. As can be seen from this list, the subjects that are addressed in arbitration cases relate to key issues in international investment law.

There is little systematic information on the amount of damages awarded so far. Claims can be very high; in the case of three arbitrations brought by the majority shareholders in Yukos, they are reported to total US$33 billion.[18] But this does not mean that arbitrators will award high amounts, even if they find in favor of a claimant. For example, 21 disputes reached a conclusion during 2006; however, out of a total of US$1.63 billion in claimed damages, arbitrators awarded only US$241.2 million, or 15% of the claimed damages.[19]

---

18 UNCTAD, "Latest Developments in Investor-State Dispute Settlement," IIA Monitor, No. 4 (2005) (UNCTAD/WEB/ITE/IIT/2005/2), p. 379, reprinted in the annex to this volume.

19 UNCTAD 2006, p. 6.

But awards *can* be high: a tribunal awarded to CSOB under a contract case (on 29 December 2004) US$824 million (plus US$10 million as a partial contribution to the costs, expenses and counsel's fees) in its case against Slovakia; in the Lauder case, the claimant was awarded (3 December 2001) US$270 million (plus interest) against the Czech Republic; and CMS Gas Transmission Company was awarded (15 May 2005) US$133.2 million (plus interest) against Argentina.[20] In other words, awards can be substantial, without even counting the costs of litigation.[21]

This surge in investment disputes is not necessarily a problematic matter in and of itself, as disputes are normal in any rule-based system. In fact, it is surprising that the number of disputes had not started to rise much earlier and had not reached considerably higher magnitudes, considering the growth of the stock of foreign direct investment, the intrusiveness of FDI and the great number of IIAs with dispute settlement provisions. But things seem to be changing, judging from the developments during the past few years reported earlier. This raises questions related to the financial burden of awards and the costs of dispute settlement for the countries involved, the potential damage disputes can do to the relationship between investors and host countries, the capacity of countries to handle such disputes, and the effect the surge of disputes can have on the negotiation of IIAs. But it also raises the questions of whether the multitude of one-off tribunals established to deal with investment disputes can—and does—lead to inconsistencies in the interpretation of IIAs and how one can meet this challenge, including through the establishment of a review mechanism for arbitral decisions.

More specifically, against the background of the rise of FDI, IIAs and investment disputes, the contributions in this volume look, in its Part I, at the multifaceted nature of international investment law and the future of this law. Part II, then, deals with the evolving nature of international investment law, recent trends in international investment disputes and the reasons for the increase of such disputes. In Part III of this volume, a number of issues directly pertaining to investment disputes are addressed, before examining, in Part IV the question of an appellate mechanism in international investment disputes.

---

20 UNCTAD, *Investor-State Disputes Arising from Investment Treaties: A Review* (United Nations Publication: 2005), p. 9.

21 UNCTAD 2006, p. 6 observes: "a few recent decisions … seem to reinforce the recent trend that allocates (at least part of) the legal fees and arbitration costs to the losing party, whether the State or the investor." It continues to list a few cases, including the decision (2 October 2006) of the ADC tribunal to award the full costs of US$7.6 million (which included the investor's legal costs) to the defending country.

Most of these chapters were presented at the Columbia Program on International Investment Symposium on "Transparency and Consistency in International Investment Law: Is There a Need for a Review Mechanism?," 4 April 2006, held at Columbia University, in cooperation with the *Centre d'Études et de Recherches de Droit International* of Sorbonne University Panthéon-Sorbonne. A number of the commentaries made on that occasion are included as well, as is the summary by the rapporteur of the Symposium. Finally, the annex contains documents that bear directly on ICSID's proposal for the establishment of a review mechanism, as well as materials that provide context for this proposal and hence deal with the rise of international investment disputes and the proliferation of international investment agreements.

The international investment law system is in a phase of rapid change. Disputes, and reactions to them, contribute to that process. Making sure that the various components of this system are consistent and coherent, that its processes are transparent and that all participants feel that it serves their interest can only strengthen the rule of law governing this important economic activity, complementing—and reinforcing—the national regulatory investment frameworks of individual countries.