8th INVESTMENT TREATY ARBITRATION CONFERENCE

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Keynote Address by George Kahale, III

First I want to thank the organizers of this conference for giving me the privilege of addressing you this morning on one of the hottest topics in international law today: ISDS. As some of you may know, I have long been both a beneficiary and a critic of ISDS. I say beneficiary because I've been fortunate enough to have been entrusted with the defense of many ISDS claims. At the same time, I cannot help but recognize that this is a deeply flawed system, a system I have previously referred to as the Wild Wild West of international practice.

I referred to it as such for a number of reasons, with which I'm sure this audience is quite familiar. On the substantive side, the damage done in the name of basic concepts such as fair and equitable treatment has been palpable. In far too many cases, what formerly would be considered legitimate government regulation is characterized as breaches of treaty obligations that the treaty negotiators never thought existed. This gross misapplication of international law is troublesome enough, but combined with the dispute settlement mechanism of international arbitration, investment treaties have been transformed into what I call "weapons of legal destruction."

In today's ISDS, an investor assisted by competent counsel and the growing crowd of experts who support them, often armed by third party funders, can conjure up an investment claim based on virtually any governmental action. And it seems that no matter how far-fetched the claim is, the investor has at least a puncher's chance that some tribunal will actually find it meritorious. With the lack of the normal safeguards of a serious legal system, many strange and frankly indefensible decisions have been rendered, which then are used as precedent to justify still further departures from anything resembling what the States signed up for when they entered into these treaties.

I think it's important to note that these departures generally only go in one direction, that is, expanding the scope of investor protection. It's relatively easy to find cases in point, but I would challenge anyone to find an example of a case restricting investor protection beyond what was contemplated by the parties to an investment treaty.

More and more States are finding this one-way street frustrating, especially when they are on the receiving end of one of these awards. They are suspecting that there is bias in the system. I'm sure you are aware of the statistical studies on this, all of which are very interesting, but I prefer to trust my eyes and ears, and my eyes and ears tell me there is a definite bias in the system against States. In my view, statistical studies proving that States can and often do win cases do not refute that basic conclusion. We also need to recognize that in this business, even if the number of outrageous decisions each year is one, that is one too many, given what's at stake in terms of matters of principle and, in many cases more importantly, money, which brings me to quantum.

In thinking about what might be useful to stress today, I settled on quantum because too often too little attention is paid to it, especially by lawyers, who tend to be less comfortable dealing with quantum than they are with jurisdiction and the merits. Arbitrators also tend to be less comfortable with quantum, as they often have little or no training in that area. This means that the members of the club of quantum experts play a vital and increasingly dangerous role in ISDS cases.

The five points I'd like to stress on quantum begin precisely with the role of the experts. Counsel and arbitrators should exercise extreme caution in the use of experts and avoid ceding the entire ground to them. For lawyers, the first important step in doing that is to master the quantum issues in order to understand what the experts are saying and to make sure they have the right focus, to understand exactly what the value drivers are, to effectively cross-examine the other side's experts, and to effectively present the case to the tribunal. Without that basic knowledge and comfort level, the lawyer is at a distinct disadvantage, which can prove very costly.

The second point to note on quantum is the sheer size of the claims in today's ISDS. There was a time not too long ago when a 50 million dollar claim was considered huge. Not in this new age of the megacase. That's why I say the system has become downright dangerous. We don't know what the ultimate outcome of the *Yukos* 50 billion dollar award against Russia will be in the Dutch courts, but one can guess that if the award is reinstated, Russia might not be too quick to write a 50 billion dollar check. Frankly, I doubt the U.S. would be if it ever suffered such an award, or even a much smaller one, at least not while Mr. Trump is in the White House. And while *Yukos* is somewhat of an outlier, with a claim of over 100 billion and an award more than twenty times the largest ever rendered before that time, other surrealistic claims in the range of 20 to 30 billion and even more can be found. With the proliferation of these multibillion dollar claims, you can see why I say this has become an area where even one mistake a year is too much, and if experience has taught us anything, it is that mistakes are not that rare in this business.

My next two points on quantum have to do with the discounted cash flow methodology used for valuation.

The object of DCF is to ascertain the fair market value of an interest by estimating the future cash flows it is expected to generate and then applying a discount rate to arrive at a net present value. By definition, this requires projections, or assumptions, as to each of the inputs into the cash flows, including operating costs, capital expenditures, taxes, production, sales and prices, over the life of the project, which could be 20, 30 years or longer. No one has that kind of crystal ball. The only thing that is virtually certain is that those assumptions will turn out to be wrong. If you thought the concept of fair and equitable treatment is susceptible to abuse, you haven't seen anything until you've seen what an imaginative claimant supported by its experts can come up with in quantum using DCF. As one respected analyst, Dr. Stauffer, wrote in 1996: "The DCF method has indeed been tainted by misapplication, and it has been used to justify valuations which reach beyond the 'fanciful' to 'wonderland proportions'."

A few years earlier, the World Bank Guidelines on the Treatment of Foreign Direct Investment contained an extraordinary warning that unfortunately has not received enough attention. It stated: "Particular caution should be observed in applying this method [DCF], as experience shows that investors tend to greatly exaggerate their claims of compensation for lost future profits." That warning is for cases in which the use of DCF is considered appropriate under the Guidelines, but before you get there you have the threshold issue of whether DCF is even appropriate.

Under the Guidelines, DCF is not appropriate to value a business that is not a "going concern." A going concern is one that has a proven track record of profitability. That makes perfect sense. Why? Because while some degree of speculation as to the future may be acceptable where you have a track record of profitability, projecting cash flows over a period of 20 or 30 years without any track record, without knowing whether the business would ever be successful, crosses over into the realm of fantasy.

This threshold issue of whether it is appropriate to use DCF is relatively easy for lawyers and arbitrators to grasp, as it is grounded in common sense as well as in law. A claimant has the burden of proving all elements of its claims, including damages, and it is hard to see how that burden can be carried when the degree of speculation reaches "wonderland proportions."

Quite a few cases have rejected the use of DCF either because the business being valued had no track record at all or because it had been in operation for too short a period to provide reliable data for projecting future performance. They include early cases, such as *SPP* and *Wena Hotels*, and more recent cases, such as *Caratube* and *Bear Creek*.

Nevertheless, there are many examples of claimants making billion dollar claims based on relatively insignificant investments in businesses that never commenced operations. In one case against Nigeria, a claimant managed to obtain an award of 6.6 billion dollars for a gas refining business for which the plant had not even been built. With interest, the award has reached an incredible 9 billion. A case against Libya resulted in an award of nearly a billion dollars on a tourism project that never got started. Only about five million had been invested. One has to ask: at what point will these awards become so shocking that the international arbitration community, and indeed the international community at large, will say “enough is enough”?

The fourth point I wanted to stress on quantum relates to the determination of the appropriate discount rate – that’s for cases where it is appropriate to use DCF. Getting the discount rate wrong can mean losing hundreds of millions if not billions of dollars.

Once again, one need not search far and wide for examples that show that this is not an academic point. In *Gold Reserve*, the tribunal applied a 10.09% discount rate in valuing a gold mining interest in Venezuela. The result was an award of US$713 million. The key factor in the tribunal’s decision on discount rate was its approach to the issue of country risk, where it essentially accepted the view of claimant’s economic expert. That same economic expert appeared for the claimants in the *Tidewater* case, making the same basic arguments on country risk for the same country, Venezuela, but this time unsuccessfully. The tribunal in *Tidewater* applied a discount rate of approximately 26%. Obviously, had that rate been applied to value the interest in *Gold Reserve*, the result would have been dramatically different.

These are examples the arbitration community has been quite familiar with for some time, but now we have another case that frankly has to take even the most claimant-friendly audience aback. That is the case against Nigeria I referred to earlier. It is actually not a treaty case, but one in which the same type of DCF exercise was performed. To come up with its 6.6 billion award, the tribunal accepted the claimant's argument in favor of applying a 2.65% discount rate. Now you might ask: how can a business in Nigeria that never got off the ground command a 2.65% discount rate when the rate applied by the two *Mobil* tribunals for an oil project in Venezuela producing 120,000 barrels of oil per day was 18% in 2007, when Venezuela was not in an economic crisis? As I said, the difference between applying one discount rate rather than another can be measured in the billions, and the Nigerian case is a vivid illustration of that point.

The fifth and last point I will make on quantum is that interest is a concept distinct from the discount rate. The latter is supposed to reflect risks inherent in the project; the former is not, and by definition should be much lower than the discount rate, as many tribunals have recognized. But as I said earlier, in this business new developments always go in one direction, and in June we saw a tribunal actually apply an interest rate of 15.2% compounded monthly, hard as that may be to believe.

What can be done about all this? As you know, UNCITRAL Working Group III, whose next session begins in a few days, is working away at the issue of whether to reform ISDS and, if so, how. That is a positive step in the sense that anything that focuses attention on the glaring deficiencies of the system is praiseworthy. But to be honest, I don't hold out much hope that serious reform will emerge anytime soon, and have previously expressed concern that the cure might even be worse than the disease. Two reasons why I say that are: (i) there is always a tendency to try to accommodate all supposed stakeholders, which in this case would be a recipe for disaster, and (ii) substantive issues are actually excluded from the scope of the Working Group's mandate. How can you reform the system without addressing the core substantive problems?

That's why I have argued that the system should be dismantled and either discarded or rebuilt from scratch, with a set of substantive rules that have a solid foundation in international law. Those substantive rules should go beyond the traditional ISDS issues of FET, FPS, expropriation and MFN, and extend into the recurring quantum issues, including the ones I have touched on today, as you can see that giving short shrift to quantum can be a very costly proposition. This is an exercise that should be done regardless of whether ISDS continues in its current form, is reformed, or is dismantled. The danger of inaction on the substance increases with each new award that leaves us scratching our heads and asking how in the world that could have happened.

So I propose a three-pronged approach:

- First, with respect to UNCITRAL Working Group III, continue focusing attention on the deficiencies of the system, but do not expect a magical solution to emerge and beware of any proposal designed to please all stakeholders. Most importantly, do not suspend action on the second and third prongs.

- Second, actively explore termination of ISDS provisions in investment treaties and trade agreements. The United States just did that in the NAFTA renegotiation, ending ISDS with Canada and limiting it with Mexico. I do not agree with the motivations behind that action, which appear to be some combination of discouraging investment abroad and skepticism about any international tribunal or even international law itself. But ending or limiting a system as defective and dangerous as ISDS is a good thing, even if it is done for the wrong reasons.

- Finally, recognizing that it won't be easy to terminate ISDS in all treaties, substantial effort should be devoted to substance, putting the brakes on this out-of-control development of a new body of law. States should seek agreement on interpretations of the substantive concepts in their treaties. There are of course differences in treaty language, but there are also common themes and recurring issues that cry out for uniform interpretation. How hard can it be to reach agreement once and for all that FET does not extend beyond MST; that, as indicated by the International Court of Justice earlier this month in the *Bolivia v. Chile* case, legitimate expectations is not a general principle of international law; that customary international law is not created by decisions of arbitral tribunals in ISDS; that MFN should not be used to create consent where consent does not exist and should not be used to import substantive provisions that were not intended by the negotiators and render the entire treaty-negotiation process meaningless; that DCF should not be used to value a business that never even got started; and that discount rates, in contrast to interest rates, must reflect all risks in the cash flows. States routinely take these positions when claims are made. I say why wait for the claims to come?

In the meantime, for so long as ISDS continues, my advice to States is to hope for the best but always prepare for the worst, because it might be coming even in cases where the real principles of international law and common sense would say otherwise.

Thank you for your attention, and I wish you a great conference exploring these and the other important issues on the agenda.