UNCITRAL WORKING GROUP III

POSSIBLE REFORM OF THE INVESTOR-STATE DISPUTE SETTLEMENT (ISDS)

ASSESSMENT OF DAMAGES AND COMPENSATION

NOTE BY THE SECRETARIAT OF SEPTEMBER 2021

EXPERT COMMENTS

PREPARED BY

DR. HERFRIED WÖSS, LL.M.
LIC. ADRIANA SAN ROMÁN, M.A.
PROF. DR. IRMGARD MARBOE

SUBMITTED BY

PROF. DON WALLACE, JR.
CHAIRMAN
INTERNATIONAL LAW INSTITUTE
WASHINGTON, D.C.

VIENNA, 9 NOVEMBER 2021

Table of Contents

1. INTRODUCTION

[1] In September 2021, the UNCITRAL Working Group III published a Note by the Secretariat on the "Assessment of damages and compensation". The expert comments below have been prepared in response to the invitation by the Secretariat to comment on the Note until November 15, 2021.

[2] The Note appears to reflect primarily the concerns of host States of foreign investment. It generally would benefit from a more balanced approach and should not lose sight of the purpose of international investment protection, which is contributing to the rule of law, predictability, and stability of the legal environment, which ultimately is in the interest of both host and home States of foreign investment. It should also be taken into account that the respective role – home or host State – is not predetermined and may change over time and from case to case. Ultimately, international investment protection aims at the containment of unlawful actions that are detrimental to economic development and too often remain without legal or financial consequences.

[3] Submissions by governments pointing to the problem of high damages awards mentioned in the Note seem to rely on outlier investment arbitration cases and give the impression that ISDS tribunals generally award very high amounts of damages. However, a recent study which analysed 241 awards until March 2020 comes to the conclusion that three awards alone accounted for 81.7% of the awarded damages and the remaining average damages awarded were US$ 55.2 million.[1] Another recent study analysing 433 ISDS awards issued until May 2020 shows that respondent States won 54% of the cases, 2% were terminated, and in the 44% of cases won by investors, the median amount awarded was US$ 21.4 million, representing a mean of 33% of the amount claimed.[2] While governments apparently argue in their Submissions to the Secretariat that the amounts claimed are inflated, it needs to be recalled that ISDS cases are often related to natural resources where the existence of gold, oil and other precious materials leads to a determination of damages which should be regarded in the light of the transfer of substantial value to the State through direct or indirect expropriation and other measures.

---

1 Timothy Hart and Rebecca Vélez, *Study of Damages Awards in Investor-State Cases*, 2nd edn., January 2021, published in 18 Transnational Dispute Settlement, Issue 3, April 2021, p. 7.

2 Matthew Hodgson, Yarik Kryvoi, Daniel Hrcka, *2021 Empiricial Study: Costs, Damages and Duration in Investor-State Arbitration*, British Institute of International and Comparative Law, June 2021, pp. 26-28.

2. OBSERVATIONS TO SOME KEY ISSUES ADDRESSED BY THE NOTE

2.1 CONSISTENCY AND COHERENCE

[4] With respect to the lack of coherence and consistency of decisions made by ISDS tribunals regarding the application of legal principles to the assessment of damages and compensation, the following could be taken into account:

[5] The Note seems to indicate that in apparently similar cases, compensation or damages should be the same or similar. However, this premise does not consider that disputes that may appear similar on the surface frequently arise from different factual circumstances, which almost necessarily leads to different results. The Note compares the results of two allegedly similar ISDS arbitrations about early-stage investments: one is *Bear Creek v. Peru*,[3] where sunk investment was awarded, and the other is *Tethyan Copper v. Pakistan*,[4] which lead to the award of a considerable amount of damages based on expected future income.

[6] In these two cases, it is important to observe a vital factual difference. In *Bear Creek*, the sunk investment was awarded because the Tribunal considered that the investor would not overcome the social resistance to the project and, therefore, the expected income stream was too speculative.[5] In *Tethyan Copper,* however, the Tribunal awarded the expected future income stream discounted to the date of valuation as it recognized that the project was likely to evolve as planned but for the unlawful actions by the organs of the respondent State.[6] As may be observed, two different measures of damages were applied due to differences in the factual situation, based on the evidence presented and its evaluation by the two Tribunals.

[7] Consistency in the application of valuation approaches and methods in ISDS is only possible in the light of identical factual situations.[7] It needs to be recognized that the facts are not the same in every arbitration, and the evidence may differ even if cases concern the same sector or the same stage of development.

[8] The alleged problem of inconsistency and unpredictability of awards on damages may be rooted in the paucity of analysis and reasoning by tribunals in some cases. Moreover, party counsel often delegate the framing of the damages claim to experts and leave it up to them to define the underlying principles for the valuation, which, in essence, is a legal issue, not for an expert to determine. This may lead to extreme positions of the experts. Accordingly, the issue is often an inappropriate division of roles, and the tribunal and codes of conduct for experts cannot always make up for this situation.

2.2 REGULATORY FREEDOM AND ILLEGALITY THRESHOLD

[9] With respect to paragraph 6 of the Note, States are free to regulate as far as they do not cross the illegality threshold under applicable international law. It may be a popular, but it is a misleading argument that "the high amount of compensation awarded by arbitral tribunals" is one of the elements that undermine States' ability to regulate. Damages are only to be awarded in relation to unlawful acts but not for legal behaviour. It is possible to reflect the proportion of the illegal act in the valuation of damages, as it is shown in the

---

3 *Bear Creek Mining Corporation v Republic of Peru*, ICSID ARB 14/21, Award of 30 November 2017.

4 *Tethyan Copper Company PTY Limited v Islamic Republic of Pakistan,* ICSID case ARB/12/1, Award of 12 July 2019.

5 See *Bear Creek*, n. 3, paras. 599-604.

6 See *Tethyan Copper Company*, n.4, paras. 1421-1422.

7 See Judge Charles N. Brower on the issue of consistency in his interview by Devin Bray at the Tenth Investment Arbitration Forum, Conference Reports of the Tenth Investment Arbitration Forum, Kluwer Arbitration Blog, November 3, 2021, Part I: http://arbitrationblog.kluwerarbitration.com/2021/11/03/the-mexican-energy-counter-reform-impact-and-the-illegality-threshold-tenth-investment-arbitration-forum-part-i/; Part II: http://arbitrationblog.kluwerarbitration.com/2021/11/03/the-mexican-energy-counter-reform-state-defense-and-damages-tenth-investment-arbitration-forum-part-ii/.

landmark case *Murphy v. Ecuador*,[8] where no damages were awarded for a tax increase to 50%, but were awarded for a tax increase from 50% (the so-called "illegality threshold") to 99%.[9] The regulatory freedom of States is limited by the scope of the applicable international law standard and not by damages *per se*. Financial compensation is only the consequence and the remedy against an illegal act attributable to States. Uncertainty over damages may also derive from the lack of precision in the scope of applicable substantive standards, such as Fair and Equitable Treatment.[10] Accordingly, uncertainty at the liability level leads to uncertainty when contemplating damages.

[10] The so-called "regulatory chill" mentioned in paragraph 9, reflecting the Submission from one government, is often caused by a lack of legal expertise in the legislative, administrative, and executive branches of government. Building up the relevant expertise could help to better understand the difference between lawful regulation and unlawful acts. Trying to blur the line between the two does not seem to be a constructive contribution in the discussion on the future of ISDS.

2.3 COMPENSATION STANDARD OR MEASURE OF DAMAGES AND CAUSALITY

[11] The Note states in paragraph 17 that the compensation standards do not differentiate between indirect and direct unlawful expropriations and seems to indicate that the violation of different international law standards requires a different measure of damages. However, the but-for premise or differential hypothesis is applicable to a variety of different scenarios. In its well-known dictum, the Permanent Court of International Justice in the Case *Factory at Chorzów* stated that "reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed."[11]

[12] It follows that arbitral tribunals have to compare two situations: the economic situation subject to the illegal measure and the hypothetical situation in the absence of the illegal measure.[12] This method would already take into consideration whether there is a total or partial, temporary or indefinite illegal impairment or loss of the investment. Therefore, there is no need for different measures of damages or standards of compensation for different measures violating different international law standards. The but-for method aims at compensating damages for the precise violation, i.e. aims to put the injured party into the position it would have been in the absence of the illegal measure.

[13] While the Fair Market Value is the standard for lawful expropriations in international investment agreements, it can also be used – if appropriately applied – in other cases. The issue is then to determine the economic difference between the actual value of the investment and the value it would have in the absence of the illegal measure. It follows that the economic difference to the value is calculated, but the compensation is not the value of the investment as such, if the measure has not led to a complete deprivation or destruction of the investment.

---

8 *Murphy Exploration & Production Company - International v. The Republic of Ecuador,* PCA, Partial Final Award of 6 May 2016.

9 Ibid, paras. 441-451; see also Herfried Wöss and Adriana San Román, 'Damages in Investment Treaty Arbitration', in: José Rafael Mata Dona, Nikos Lavranos (eds.), *International Arbitration and EU Law* (Edward Elgar Publishing 2021), paras. 17.73-85.

10 Herfried Wöss, 'Systematic Aspects and the Need for Codification of International Tort Law Standards in Investment Arbitration', in: *The Comprehensive Economic and Trade Agreement between the EU and Canada (CETA)*, (2016) 13 TDM Special on CETA 1.

11 *Case Concerning the Factory at Chorzów* (Claim for Indemnity), Judgement, 13 September 1928, PCIJ Series, A, No. 17, p. 47.

12 Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law* (British Institute of International and Comparative Law 2008), pp. 83-90. See also Borzu Sabahi, *Compensation and Restitution in Investor–State Arbitration: Principles and Practice* (Oxford University Press 2011) p. 56-60; Irmgard Marboe, *Calculation of Compensation and Damages in International Investment Law*, 2nd ed. (Oxford University Press, 2017), p. 37-40; Irmgard Marboe, *Damages in Investor-State Arbitration: Current Issues and Challenges* (Brill 2018), pp. 25-27 and 39-41.

[14] In order to be precise, the application of the but-for premise may lead to the Fair Market Value in case the actual value of the investment is zero. What is important is that the Fair Market Value implies the hypothetical normal course of events.[13]

[15] With respect to the "full reparation principle", it is important to clarify that this principle was not first introduced in the *Factory at Chorzów* case but dates back to Greek philosophy and ethics. Damages law is based on the *Aristotelian* (384-322 BC) notion of "commutative justice" in his Nicomachean Ethics[14] as further developed by *Thomas Aquinas* (1225-1274) in his *Summa Theologica*.[15] *Hugo Grotius* (1583-1645) established the leading natural law damages doctrine in Chapter 17 of his masterwork *De iure belli ac pacis*, based on total reparation and the compensation of damages and lost profits, which is applicable to the violation of different kinds of legal positions, including property, contract and law.[16] Grotius' doctrine was further developed by *Samuel Pufendorf* (1632-1694) according to whom damages law was understood as a defence against the "no-harm" rule (*neminem laedere)* and focused on the position of the injured party[17] as already established under the Roman law maxim *'id quod interest'*. The *Chorzów* formula adopts the but-for premise which has been developed under English and German law already in the mid-19th century.[18]

[16] The full reparation principle mandates to avoid over- and under-compensation. This is achieved through the but-for premise, or differential hypothesis, whereby the injured party should be put in the position it would have been without the illegal measure. Therefore, the reference in paragraph 18 of the Note that the principle of "full reparation" finds its origin in the *Chorzów* judgement has to be seen in the context of its historical development. The recently concluded investment treaties mentioned in paragraph 23 of the Note do not change anything in this respect. The exclusion of "punitive damages", the confirmation that the "compensation awarded shall not be greater than the loss suffered by the investor" or the requirement of a "sufficiently close nexus to the harm" only confirm the existing rules under the law of State responsibility. While States could have chosen alternative formulations, such as "just satisfaction" in Article 41 of the European Convention on Human Rights, they did not do so. On the contrary, the chosen formulations in recent investment treaties – probably for a good reason and in the interest of both host and home States of foreign investment – merely confirm the full reparation principle.

[17] Full reparation is not synonymous with the Fair Market Value but the latter is often used in ISDS to measure the difference between the actual value of the investment after the illegal measure, and the hypothetical Fair Market Value of the investment in the absence of the illegal measure.

[18] Paragraph 20 of the Note states that decisions on investment treaty disputes have shown a primacy of compensation over restitution. The reference to the WTO system is not convincing, because the WTO Dispute Settlement Body does not order any remedy but leaves it up to the parties to choose the most appropriate way of addressing the violation, which may include restitution, compensation, or retaliation. The issue is not whether restitution is more or less intrusive, but which remedy can place the injured party in the situation it would have been had the illegal measure not occurred. Furthermore, the

---

13 Herfried Wöss and Adriana San Román, 'Damages in Investment Treaty Arbitration', op. cit., paras. 17.17-33, 17.37-39; Herfried Wöss, Ariana San Román, Pablo T. Spiller, Santiago Dellepiane, *Damages in International Arbitration under Complex Long-term Contracts* (Oxford University Press 2014), paras. 5.198-9.

14 Gerard J. Hughes, *The Routledge Guidebook to Aristotle's Nicomachean Ethics* (Taylor Francis Group 2013).

15 James Gordley, *Foundations of Private Law: Property, Tort, Contract, Unjust Enrichment* (Oxford University Press 2006) 423-34.

16 Hugo Grotius, *De iure,* lib. II, cap. XVII, §§IV f, cited in: Feras Gisawi, *Der Grundsatz der Totalreparation,* Grundlagen der Rechtswissenschaft 25 (Mohr Siebeck 2015) 28-9.

17 Samuel Pufendorf, 'Ut nemo laedatur, et si quod damnum fuit datum, reparetur', in: *De iure belli ac pacis,* lib. III, cap. I, §2, cited in: Feras Gisawi, *Der Grundsatz der Totalreparation,* p. 44.

18 Hersch Lauterpacht, *Private Law Sources and Analogies of Law* (Longman, Green & Co. Ldt. 1927) p. 6; Idem, *The Development of International Law by the International Court* (Cambridge University Press 1958) p. 32.; *Robinson v. Harman* (1848) 13 P.D. 191 (C.A.) 200; Friedrich Mommsen, *Beiträge zum Obligationenrecht:* Abth. *Zur Lehre von dem Interesse* (E.U. Schwetschke und Sohn 1855).

relationship between the investor and the State usually have deteriorated due to the dispute so that investors only claim compensation. Generally, also States prefer compensation because they regard it as less detrimental to their sovereignty than restitutions. That is the reason why restitution is hardly used as a remedy in investment arbitration.

[19] With respect to paragraphs 21 to 23 of the Note, the but-for premise established in the *Chorzów* dictum applies to any kind of illegal State measures and allows for the compensation of precisely the illegality portion of State conduct as already mentioned above.

2.4 VALUATION AND EVIDENTIARY REQUIREMENTS

[20] One of the most important issues in the valuation of damages and compensation is evidence. In particular, the proof of causation is of utmost importance. A special feature in ISDS is that the State influences the political and economic circumstances prevailing in its territory. With this background, establishing the causal connection between a specific treaty violation and the damage caused is certainly not an easy task.[19] The standard of compensation or measure of damages and the standard of causation are determined by the applicable legal rules. Some investment protection treaties also enumerate a number of valuation methods that can be used by way of example.

[21] In this sense, according to *Chorzów,* the applicable standard requires placing the injured party in the economic position it would be but for the illegal measure. This means that the evidence is essential to prove the economic situation caused by the illegal act and the economic position of the injured party but for the illegal act, i.e. the reconstruction of the hypothetical normal course of events. These two situations have to be set out convincingly and the economic differential be calculated, for damages to be awarded.

[22] The Fair Market Value is usually described as the price a hypothetical willing buyer would pay a hypothetical willing seller in a situation in which both have similar knowledge and are not under any constraints to buy or sell. Generally, this price depends on the income stream of an asset. However, there are also other valuation methods used by market participants. If only one valuation method was permitted but there was not enough evidence for using that method, the injured party would be unduly restrained in proving its damages case, which could lead to a denial of justice or at least under-compensation. The valuation method has to be the most appropriate according to the circumstances of the case and the evidence available.

[23] With respect to paragraph 68 of the Note, the development of guidelines and standards to be provided to arbitral tribunals on the legal framework for the assessment of damages and compensation and the application of calculation methods would certainly be welcome. This can be done on the basis of the existing legal rules and available valuation methods and may facilitate a more coherent application of “best practices” in ISDS. On the other hand, it does not seem to be necessary to develop new “relevant provisions” on procedural issues if these would require the application of a particular valuation methodology and limit the free assessment of evidence, which is necessary to appropriately consider different facts and circumstances in international investment disputes.

[24] The different damages awarded in *Tethyan Copper* and *Bear Creek* are the result of the application of different valuation methods because of different facts and circumstances. In *Bear Creek*, the Tribunal decided to award the sunk investment and in *Tethyan Copper,* the Tribunal awarded damages based on expected future prospects and applied the discounted cash flow (DCF) method. The Tribunals in each case reflected the respective circumstances to provide appropriate relief to the injured parties. The cost-based approach is always backward-looking (from the commencement of the investment until the date of

---

19 Irmgard Marboe, *Damages in Investor-State Arbitration: Current Issues and Challenges* (Brill 2018), pp. 5-6.

valuation),[20] whereas the income-based approach considers the value from the date of the illegal measure to the date of valuation and from the date of valuation to the end of the investment project. The fact that the respondent State received considerable value through the taking due to the evidenced copper and gold reserves in the respective area might also have been a motive for the decision.[21]

[25] In distinguishing *Bear Creek* and other cases, the *Tethyan* Tribunal stated that:[22]

> *In the Tribunals view, a review of recent case law, including but not limited to the cases set out in more detail above, confirms that the question whether a DCF method (or a similar income-based valuation methodology) can be applied to value a project which has not yet become operational depends strongly on the circumstances of the individual case. The first key question is whether, based on the evidence before it, the Tribunal is convinced that in the absence of Respondent's breaches, the project would have become operational and would also have become profitable. The second question is whether the Tribunal is convinced that it can, with reasonable confidence determine the amount of these profits based on the inputs provided by the Parties' experts for this calculation. If the Tribunal reaches the conclusion that there are* "fundamental uncertainties" *due to which it is not convinced that the project would have reached the operational stage and would have been able to generate profits, it cannot apply the DCF method. If it reaches the conclusion that no such* "fundamental uncertainties" *preclude reliance on the DCF method but it is not convinced by the inputs provided by the Parties' experts, it may conclude that it cannot apply the DCF method or it may conclude that certain deductions have to be made to account for additional risks or uncertainties faced by the project.*

[26] With respect to paragraph 31 (Choice of valuation method) of the Note, whether the investor is facing a full and permanent loss of the investment or only a partial loss of the investment for a determined period of time, is resolved under the but-for premise but does not have anything to do with the appropriate valuation method. Any valuation method can be used in connection with the but-for premise.

[27] Concerning possible future work on valuation methods referred to in paragraphs 71 to 75 of the Note, it needs to be considered that the proposed capping of compensation, for instance to the amount actually invested by the investor, would limit the ability of tribunals to assess the facts and circumstances of each case in light of the applicable rules of international law. It needs to be taken into account that limitations of valuation methods contrasting current investment treaties could favour unlawful acts by States when investments turn out to be profitable.

[28] With respect to the standard of proof addressed in paragraph 43 of the Note, the *Chorzów* formula already establishes a standard of proof when referring to *"in all probability"* which is a rather high standard.[23]

3. CONCLUSIONS

[29] Developing guidelines and standards to be provided to arbitral tribunals on the legal framework for the assessment of damages and compensation and the application of calculation methods is welcome and can be done on the basis of the existing legal rules and available valuation methods. They may facilitate a more coherent application of “best

---

20 The date of valuation could be the date of the illegal measure, the date of the award or another date appropriate according to the circumstance and the applicable provision (expropriation or violation of other treaty standards).

21 *Tethyan Copper Company PTY Limited v. Islamic Republic of Pakistan,* ICSID Case ARB/12/1, Award of 12 July 2019, paras. 178-181

22 *Tethyan Copper Company PTY Limited v. Islamic Republic of Pakistan,* Award of 12 July 2019, para. 330.

23 'Reparation must, so far as possible, wipe out all the circumstances of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed ...', *Case Concerning the Factory at Chorzów (Claim for Indemnity),* Judgment, 13 September 1928, PCIJ Series, A, No. 17, p. 47.

practices" in ISDS. On the other hand, it does not seem to be necessary to develop new "relevant provisions" on procedural issues if these might be in conflict with the law of State responsibility and basic procedural principles, such as the free assessment of the evidence.

[30] Damages are necessarily connected to liability through causality as set out in the but-for premise established in the *Chorzów* formula. Accordingly, uncertainty at the liability level leads to uncertainty in damages assessment. Building up legal expertise is essential to understand and implement better the distinction between lawful regulation and unlawful acts.

[31] The but-for premise, or differential hypothesis, found in the *Chorzów* formula already takes into consideration whether there is a total or partial, temporary or indefinite loss or impairment of a foreign investment. Therefore, there is no need for different measures of damages or standards of compensation for different measures violating different international law standards.

[32] Consistency in awards on compensation and damages could be pursued with respect to the applicable rules of international law and the use of generally accepted valuation methods. However, different factual situations and circumstances may require different valuation methods. This is also reflected in the practice of prices achieved between buyers and sellers on the market. Consistent application of a cost-based approach, for example, would only be possible in the light of identical factual situations which rarely exist. The evidence may differ even if similar cases relate to the same sector or the same stage of development.

[33] The alleged problems of inconsistency and exaggerated awards on compensation and damages emphasised in the Note by the Secretariat appear exaggerated themselves. A small number of high awards against respondent States should not be taken as a reason to jeopardize the entire system of international investment protection. A reliable legal framework is essential for the development of infrastructure and other large projects, which often need foreign investment. The legal protection of foreign investment is therefore an important tool to promote the UN sustainable development goals. If the system of ISDS is seriously undermined, unlawful governmental activities will remain without legal and financial consequences, which is not only to the detriment of foreign investors – which usually have the alternative to invest in other countries – but also to the detriment of the populations of the countries themselves. Leaving foreign investors without appropriate protection of their investments not only increases their risk and, therefore, the price of projects, but could also favour unlawful behaviour by States. Lack of investment decreases the chances of sustainable development as may currently be observed in different parts of the world.