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Possible reform of investor-State dispute settlement (ISDS)

Assessment of damages and compensation

Note by the Secretariat

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I. Introduction

1. At its thirty-fourth session in 2017, the Working Group considered issues of coherence and consistency of decisions made by ISDS tribunals and noted that there had been inconsistent decisions regarding the application of legal principles to the assessment of damages and compensation (A/CN.9/930/Add.1/Rev.1, para. 30).

2. At its thirty-seventh session in 2019, the high amount of compensation awarded by ISDS tribunals was mentioned as a concern as it undermined States' ability to regulate (A/CN.9/970, paras. 36–38).

3. At its thirty-eighth session in 2019, the Working Group requested the Secretariat to consider how possible work on damages and compensation could be undertaken (A/CN.9/1004*, para.104). A suggestion was made that any work on this topic would require careful examination of the phase when ISDS tribunals assessed damages and determined compensation, the evidentiary requirements, the applicable accounting and financial standards and the relationship with cost allocation (A/CN.9/1004*, para. 102). The impact of third-party funding on the amount of compensation claimed was also mentioned (A/CN.9/1004*, para. 80).

4. Submissions received from Governments ("Submissions") noted the issue of assessment of damages and compensation as a concern, underlining the inconsistency and unpredictability of awards on damages.[1]

5. A Submission referred to the "vast differences between the amounts invested and the amounts awarded as compensation"; noted that ISDS tribunals "generally do not take contextual factors into account"; and stressed that the high amounts awarded could result in a "regulatory chill".[2] Another Submission noted that claimants tend to claim exaggerated compensation "in the hope that a less exaggerated but still indefensible amount will seem reasonable by comparison".[3] The Submission further referred to the large gap between claimants' and respondents' valuations of damages and called for a clear valuation method to curb the risk of abuse.

6. That Submission underlined that "guidelines on compensation" should contain a "checks-and-balances mechanism for claims, an established method for the valuation of businesses in accordance with internationally recognized standards in financial reporting, (…) and a mechanism to dismiss frivolous claims at an early stage."[4]

7. Another Submission suggested the preparation of an objective and transparent criteria for determining the compensation and emphasized that it was important that the amount of compensation is commensurate with the actual damage suffered.[5]

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[1] The following Submissions referred to damages: Indonesia (A/CN.9/WG.III/WP.156), European Union and its Member States (A/CN.9/WG.III/WP.159/Add.1), Colombia (A/CN.9/WG.III/WP.173), Ecuador (A/CN.9/WG.III/WP.175), South Africa (A/CN.9/WG.III/WP.176), Chile, Israel, Japan, Mexico and Peru (A/CN.9/WG.III/WP.182), Burkina Faso (A/CN.9/WGIII/WP.199).

[2] A/CN.9/WGIII/WP.199, paras. 7, 9 and 10.

[3] A/CN.9/WG.III/WP.156, paras. 8–9.

[4] Ibid.; A/CN.9/WG.III/WP.176, para. 73.

[5] A/CN.9/WG.III/WP.161, para. 14; A/CN.9/WGIII/WP.199, para. 11.

8. Accordingly, this Note outlines key issues relevant to the assessment of damages and the determination of compensation under investment treaties, [6] including underlying legal principles and methodologies for consideration by the Working Group. [7]

9. As is the case for other documents provided to the Working Group, this Note was prepared based on published information on the topic, [8] and does not express a

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[6] The terms "damage" and "compensation" are used in this Note following the terminology of the International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts with commentaries, 2001 (ILC Articles with commentaries), available at: https://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf and which generally refer to "damage" in the sense of a harm or loss and "compensation" as a generic term for monetary sums payable for a harm to the affected party. The ILC Articles were drafted in 2001 and have recently been commended by General Assembly Resolution in 2019 (see General Assembly Resolution A/RES/74/180, dated 27 December 2019, available at https://undocs.org/en/A/RES/74/180). The ILC Articles are not binding on States but are well recognized and broadly applied by ISDS tribunals.

[7] While this Note uses various terms, such as principle and standards, it does not take a view on whether they indeed qualify as such.

[8] For example, the following studies, reports and other background information: C. L. Beharry, ed., *Contemporary and Emerging Issues on the Law of Damages and Valuation in International Investment Arbitration* (Leiden, The Netherlands, Brill, 2018); C. L. Beharry and E. Méndez Bräutigam, "Damages and Valuation in International Investment Arbitration" (Beharry/Bräutigam), in *Handbook of International Investment Law and Policy*, J. Chaisse, L. Choukroune, S. Jusoh (eds). (Springer Singapore, 2021); J. Bonnitcha, M. Langford, J. M. Alvarez-Zarate, Daniel Behn, Damages and ISDS Reform: Between Procedure and Substance, 2021, *Journal of International Dispute Settlement*, 2021, 00, 1–34, https://doi.org/10.1093/jnlids/idab034 (Academic Forum paper); M. Hodgson, Y. Kryvoi, D. Hrcka, 2021 *Empirical Study: Costs, Damage and Duration in Investor-State Arbitration* (June 2021) (BIICL study); J. Y. Gotanda, Compound Interest in International Disputes Vol. 34 (2002–03) *Law & Policy in International Business,* p. 394 (Gotanda); T. H. Hart and R. Velez, "Study of Damage Awards in Investor-State Cases", *Transnational Dispute Management*, (January 2021), available at: https://www.transnational-dispute-management.com/journal-advance-publication-article.asp?key=1870 (Hart/Velez Study); International Institute for Sustainable Development (by J. Bonnitcha, S. Brewin), Best Practises Series: Compensation under Investment Treaties, available at: https://www.iisd.org/publications/iisd-best-practices-series-compensation-under-investment-treaties ("IISD"); J.E. Kalicki, A. Joubin-Bret, *Reshaping the Investor-State Dispute Settlement System,* Nijhoff International Investment Law Series, Band: 4 (BRILL, 2015); Kantor, The Impact of Contributory Investor Conduct: Only with Difficulty Commensurable, in M. Kinnear, G. R. Fischer, et al., *Building International Investment Law: The First 50 Years of ICSID*, 2015 (Kantor); M. Kantor, *Valuation for Arbitration: Compensation Standards, Valuation Methods and Expert Evidence* (Kluwer Law International, 2008); R. Knieper, *Rethinking Investment Arbitration* (München, SchiedsVZ, 2015), pp. 25–32; I. Marboe, *Calculation of Compensation and Damages in International Investment Law*, 2nd ed. (Oxford University Press, 2017) (Marboe, Calculation); I. Marboe, *Damages in Investor-State Arbitration: Current Issues and Challenges* (Leiden, The Netherlands, Brill, 2018), pp. 39–86 (Marboe, Damages); P. Muchlinski, F. Ortino, C. Schreuer, eds., *Oxford Handbook of International Investment Law* (Oxford, Oxford University Press, 2008) ("Schreuer"); OECD Working Papers on International Investment 2012/03, Investor-State Dispute Settlement, D. Gaukrodger, K.Gordon, available at http://www.oecd.org/investment/investment-policy/WP-2012_3.pdf (OECD Working Paper); PriceWaterhouseCoopers LLP (PWC), "International Arbitration damages research, Closing the gap between claimants and respondents" (PWC Study 2015), available at https://www.pwc.com/sg/en/publications/assets/international-arbitation-damages-research-2015.pdf; PWC, "Dispute perspectives, Tribunals' conflicts of interest" (PWC Study 2016), available at https://www.pwc.co.uk/tax/assets/tribunals-conflicts-on-interest-new.pdf; PWC, "PwC International Arbitration damages research, 2017 update" (PWC Study 2017), available at https://www.pwc.co.uk/forensic-services/assets/pwc-international-arbitration-damages-research-2017.pdf; S. H. Reisberg, K. M. Pauley, "An Arbitrator's Authority to Award Interest on an Award Until 'Date of Payment': Problems and Limitations", Int. A. L. R., iss. 1 (2013), p. 25, available at https://www.willkie.com/-/media/files/publications/2013/04/an-arbitrators-authority-to-award-interest-on-an__/files/anarbitratorauthoritytoawardpdf/fileattachment/an_arbitrator_authority_to_award.pdf; B. Sabahi, *Compensation and Restitution in Investor–State Arbitration: Principles and Practice* (New York, Oxford University Press, 2011); K. Sachs and N. Schmidt-Ahrendts, "Protocol on Expert Teaming: A New Approach to Expert Evidence", in *Arbitration Advocacy in Changing Times, ICCA Congress Series, vol. 15*, A. J. Berg, ed. (Kluwer Law International, 2011); Ratner,

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view on the possible reform options, which is a matter for the Working Group to consider.

II. Assessment of damages and determination of compensation in ISDS

A. Existing framework

10. With the aim of attracting investment and contributing to predictability and stability of the legal environment, investment treaties provide protection to foreign investors through substantive guarantees and standards, such as protection from expropriation, fair and equitable treatment (FET), full protection and security, freedom of transfer of funds and non-discrimination. Investment treaties also allow investors to claim compensation in case of a breach of those obligations through ISDS proceedings.

11. While investment treaties contain compensation standards for lawful expropriation, compensations for unlawful expropriation and breach of other substantive obligations have usually been based on the principle of full reparation under customary international law.[9]

1. Lawful expropriation

12. Investment treaties generally prescribe compensation as a condition for an expropriation to be lawful, which also needs to be conducted in accordance with due process, for a public purpose, and in a non-discriminatory manner.[10] Investment treaties generally state that the compensation shall be equivalent to the fair market value of the expropriated investment prior to the expropriation (or before it became known) and that the compensation shall include interest,[11] be made without delay, and be paid in convertible or freely useable currency.[12]

"Compensation for Expropriations in a World of Investment Treaties: Beyond the Lawful/Unlawful Distinction", 111 American Journal of International Law 1 (2017), available at https://www.cambridge.org/core/journals/american-journal-of-international-law/article/compensation-for-expropriations-in-a-world-of-investment-treaties-beyond-the-lawfulunlawful-distinction/2F9D90327EC113E12FB7EDD415BBC935; S. W. Schill, "Enhancing International Investment Law's Legitimacy: Conceptual and Methodical Foundations of a New Public Law Approach", *Va. J. Int'l L.*, vol. 52, No. 57 (2011–2012); M. W. Swinehart, "Reliability of Expert Evidence in International Disputes", *Mich. J. Int'l L.*, vol. 38, iss. 2 (2017), p. 287; UNCTAD Series on Issues in International Investment Agreements II, Expropriation: A Sequel (2013) (UNCTAD); 2013-02-19J. M. Waincymer, *Procedure and Evidence in International Arbitration* (Kluwer Law International, 2012); A. C. Weber, C. A. Pascuzzo S., et al., "Challenging the "Splitting the Baby" Myth in International Arbitration', Journal of International Arbitration, Volume 31, iss. 6 (2014), p.720; The World Bank Group, *Legal framework for the treatment of foreign investment (Vol. 2): Guidelines*. (Washington) (World Bank, Vol.2), available at http://documents.worldbank.org/curated/en/955221468766167766/Guidelines.

[9] See also OECD Working Paper, p. 29.

[10] See, for instance, Japan-Morocco BIT (2020), Article 9; Brazil-India BIT (2020), Article 6.

[11] For instance, at a "normal commercial rate" (Pakistan-UK BIT (1994), Article 5(1)), or a "commercially reasonable rate" (United States of America–People's Republic of the Congo BIT (1990), Article III (1)), until payment date (Chile-Hong Kong China SAR BIT (2016), Article 10; Trans-Pacific Partnership Agreement (2016) (TPP), Article 9.8; Energy Charter Treaty (1994), Article 13).

[12] UNCTAD, p. 40.

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13. Certain investment treaties mention other elements,[13] including fair and adequate compensation and contextual factors.[14]

2. Unlawful expropriation

14. Investment treaties usually do not provide compensation standard for unlawful expropriation. Some argue that the standard for lawful expropriation should equally apply. Others argue that the full reparation principle should apply.[15]

(a) Principle of full reparation

15. The principle of "full reparation" was first used and elaborated upon in a 1928 judgment of the Permanent Court of International Justice (PCIJ) in the case *Factory at Chorzów*. The Court decided that the compensation must "wipe out" the consequences of a State's illegal act.[16] The principle was subsequently included in Article 31 of the ILC Articles, which obliges the responsible State to make full reparation for the injury caused by the internationally wrongful act.

(b) Restitution or compensation

16. In order to "wipe out" the consequences of a wrongful act, (i) the current situation after the wrongful act has to be compared with the hypothetical situation but for the wrongful act; and (ii) an effective remedy needs to be provided. *Factory at Chorzów* emphasized the primacy of restitution instead of compensation, provided that restitution was practicable.[17] Article 34 of the ILC Articles provides for three forms of remedies: restitution, compensation, and satisfaction[18] and article 35 of the ILC Articles foresees compensation only in cases of impossibility or disproportionality of restitution. The vast majority of ISDS tribunal have, however, awarded monetary damages instead of restitution.

3. Breaches of other treaty obligations

17. For breaches of other substantive obligations, such as FET or the full protection and security standard, and where treaties provide no guidance on compensation, ISDS tribunals have generally also applied the principle of full reparation outlined in *Factory at Chorzow* and the ILC Articles related to compensation. The principle of full reparation requires compensation for the injured party's actual losses. ISDS tribunals have also generally applied the fair market value standard to indirect expropriations or acts by a State tantamount to expropriation.

4. Limitation of compensation for damages

18. The application of the fair market value standard has been questioned: (i) when the investor has not been permanently and fully deprived of title and the property's

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[13] For instance, the determination of the fair market value may include going concern value, asset value including the declared tax value of tangible property, and other criteria as appropriate (see, for instance Indonesia-Switzerland BIT (2022), Article 7 (4) and EU-Singapore Investment Protection Agreement, Article 2(6).

[14] Compensation needs to reflect "an equitable balance between public interest and interest of those affected, having regard to all relevant circumstances and taking into account the current and past use of the property, the history of the acquisition, the fair market value of the property, the purpose of the expropriation, the extent of previous profit made by the foreign investor through the investment, and the duration of the investment" (see, for instance, SADC Model Bilateral Investment Treaty (2012), Article 6.2; see also the Common Market for Eastern and Southern Africa (COMESA) Common Investment Area Agreement (the CCIA) and the Pan-African Investment Code (PAIC)).

[15] Beharry/Bräutigam, pp. 11–12.

[16] Factory at Chorzów, Germany v Poland, 1928 P.C.I.J. (ser. A) No. 17 (Sept. 13).

[17] Ibid., para. 118.

[18] Article 34 of the ILC Articles lists "satisfaction" as a remedy, which might be, according to Article 37(2) "an acknowledgement of the breach, an expression of regret, a formal apology or another appropriate modality."

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value, (ii) when the investor has continued to operate its investment but with reduced return on investment; and (iii) when the investor's ability to use or control the property in a meaningful way has not been impaired.[19]

19. Some recently concluded investment treaties and model treaties have taken a more detailed and restrictive approach to compensation for damages. They have included provisions on damages (i) excluding certain types of damages, such as punitive damages;[20] (ii) prescribing limitations on the compensation that may be awarded (for example, the compensation shall not be greater than the loss suffered by the investor and should be reduced by any prior compensation);[21] (iii) requiring that the breach has a sufficiently close nexus to the harm;[22] or (iv) providing for mitigation factors in the calculation of compensation.[23]

B. Key issues

1. Valuation method

20. There are various methods to calculate the amount of compensation.[24] Neither customary international law nor investment treaties require the application of a particular valuation method, and ISDS tribunals usually have the discretion to choose among the methodology put forward by the parties.

21. The methodology used by ISDS tribunals to determine the damages can be broadly grouped into backward-looking and forward-looking approaches.

(a) Backward-looking approach

Asset-based approach

22. The asset-based approach uses either the book value or the replacement value of the assets in question. The book value is an accounting method that considers the

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[19] Beharry/Bräutigam, pp. 14–15.

[20] Canada-EU Comprehensive Economic and Trade Agreement (CETA) (2016), Article 8.39(4); The Netherlands Model BIT (2019), Article 22(4); EU-Singapore Investment Protection Agreement (2018), Article 3.18; SADC Model BIT, Article 29.19.

[21] See Netherlands Model BIT (2019), Article 22 (3); EU–Singapore Investment Protection Agreement (2018), Article 3.18; EU-Viet Nam Investment Protection Agreement (2019), Article 3.53; CETA, Article 8.12 (3) and 8.39(3); India Model BIT (2015), Article 26.3; India–Kyrgyzstan BIT (2019), Article 23(3); India–Belarus BIT (2018), Article 26.3; Canada Model Foreign Investment Promotion and Protection Agreement (Canada 2021 Model FIPA), Article 40 (5).

[22] TPP, Article 9.29 (4): "(…) the only damages that may be awarded are those that the claimant has proven were sustained in the attempt to make the investment, provided that the claimant also proves that the breach was the proximate cause of those damages. (…)"; Canada 2021 Model FIPA, Article 40 (5).

[23] See Indian Model BIT (2015), Article 26.3; India–Belarus BIT (2018), Article 26.3.

[24] Using different valuation methods could lead to very different results. For instance, the cases *Tethyan Copper Company PTY Limited v Islamic Republic of Pakistan* (ICSID case ARB/12/1, award dated 12 July 2019) and *Bear Creek Mining Corporation v Republic of Peru*, (ICSID ARB 14/21, award dated 30 November 2019) involve both mining projects in the exploration/approval stage. In the *Tethyan Copper* case, the State did not issue a required mining lease, and in the *Bear Creek* case, the State cancelled the investor's approval to build a mine. In both cases, the mines were not built, so the investments were not going concerns. Both ISDS tribunals found that there was an indirect expropriation and that the damages should reflect the fair market value. In *Tethyan Copper*, the tribunal performed a DCF analysis and estimated the amount of copper and gold in the deposit that the investor was going to mine, estimated the market price of these mines for the entire operating life span of the mine and deducted the likely costs that the investor would have spent operating the mine over the course of its lifespan, including an account for the risk of operating the mine. Pakistan was ordered to pay roughly 4 billion USD, plus interest and costs (the investor's actual expenditure being approximately 200 million USD). The tribunal in *Bear Creek* did not use the DCF analysis, but instead used the investor's actual expenditure, which was roughly 18 million USD. See also Bonnitcha, Brewin, IISD policy brief, Compensation Under Investment Treaties: What are the problems and what can be done?, p. 4.

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value of the total assets net of accumulated depreciation, depletion and amortization minus total liabilities, whereas the replacement value is the amount the investor would have to pay to replace the asset at stake.

Historical approach

23. The historical approach takes into account the amount initially invested by the investor prior to the breach (also referred to as sunk costs).

(b) Forward-looking approach

24. The forward-looking approach seeks to capture expected investment returns and predict how the investment would have developed in the future but for the wrongful act of the State. This approach acknowledges that the value of a business is based on its ability to generate profits. The market-based and income-based approaches are examples of the forward-looking approach.

Market-based approach

25. The market-based approach compares the business interest in dispute with the value of similar businesses in the market and determines what a hypothetical buyer would have been willing to pay for the relevant investment before the act by the State. This method requires the availability of comparable data (either comparable transactions or comparable publicly trades compagnies). However, this may raise complexities as the investments at stake are often unique and there is no comparable data available.

Income-based approach

26. Income-based approach converts anticipated economic benefits into present value with the discounted cash flow (DCF) method. This approach is by far the most commonly used method in calculating the present value of future expected cash flows so as to capture future profits or returns. It does so by estimating future streams of cash flows and then discounting the amount by a rate which incorporates the risks and the passage of time.

(c) Choice of valuation method

27. When choosing the valuation method, ISDS tribunals have generally taken into account the business involved or the industry in which the business operates. For example, asset-based approach was considered appropriate where the business value derived largely from its underlying value and not from its earnings. It further depended on the information and evidence made available by the parties.[25] In practice, ISDS tribunals often resorted to a combination of valuation methods.

28. The approach to be adopted might also depend on past performance of a business and whether inputs can be reliably determined. When a business can demonstrate through past performance that it has a likelihood of earning profits in the future, a forward-looking approach might be appropriate. In other cases where investments have no firmly established income-producing capacity and no past records of profitability, backward-looking approach has the benefit of providing greater certainty.

(d) Appropriate application of DCF method

29. The DCF method seeks to capture the value of a business based on its ability to generate profits in the future, which is then discounted taking into account the time value of money and risks. Therefore, it depends on assumptions and information about expenditures, market conditions (including inflation, interest rates, and commodity prices), political and financial risks (including those in the host State's market),

[25] See Beharry/Bräutigam, p. 17.

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competitive forces, and industry outlook. The application of the DCF method for non-operating assets, for businesses with a limited history of operations, and where market-generated information is limited (especially when the investment is unique), has been questioned.[26]

30. Differences in assumptions and future projections often lead to widely differing valuations and the discount rates that should account for future uncertainties and risks are a significant source of disagreement.[27] To forecast future investment returns, ISDS tribunals must assess various variables for the entire duration that the investment was expected to create a future cash flow, including all future revenues and expenses, the capital as well as operating expenditures, additional capital requirements, and other elements. The difficulty of correctly estimating these values and the risk of speculation increases with the timeframe for which projections are made.

31. Accordingly, both the commentaries to the ILC Articles[28] and the World Bank Guidelines[29] take a cautious approach regarding the DCF method.

32. Despite these calls for caution, the DCF method is the most widely used valuation method by ISDS tribunals. A study, which analysed 95 publicly available awards, has found that tribunals increasingly rely on an income-based approach, particularly the DCF method. Between 2011 and 2015, it was used in 69% of the cases where compensation was assessed, compared to only 17% of the cases before 2000. And this has led to increasing amounts of compensation,[30] that could vastly exceed the amount that the investor has invested.

(e) Valuation date

33. The choice of the valuation date can also have a significant impact on the amount of compensation. In cases of lawful expropriation, the valuation date is usually the date of expropriation or the date before the impending expropriation became public, since public knowledge has an immediate influence on the value. In cases of unlawful expropriation or other breaches of treaty obligations, there are generally two possible valuation dates which the tribunal could consider depending on the circumstances of the case: (i) the date of the breach; and (ii) the date of the final award.[31]

2. Causation – attributing loss by an investor to the breach of a State

34. The loss claimed by an investor needs to be attributable to a wrongful act of a State in order to be compensable. Generally, appropriate standards or tests for proving causation are not included in investment treaties. Only a few treaties include language on causality, for example, that investors may obtain compensation only for losses that occur "by reason of" or "arising out of state measure".[32] More precise formulations require "that the investment, or the investor with respect to its investment, has suffered actual and non-speculative losses as a result of the breach (…)(and) that those losses were foreseeable and directly caused by the breach."[33]

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[26] Ibid.

[27] See PWC Study 2015, p. 3.

[28] ILC commentary on Article 36, paras. 26–27.

[29] World Bank Group, Vol 2, para. 42.

[30] PWC Study 2015, p. 3. See also Hart/Velez Study (2021), pp. 47, 50–51, which does not analyse the use of the DCF method over time but calculated a general average. Accordingly, the DCF method was the most commonly relied upon basis for the awarded amounts, used in 30.3% of the cases (invested costs in 23.0%, market value in 5.7% and lost profits in 4.9% of cases).

[31] The date of the award is not commonly applied. It is usually only when the asset has increased since the date of the breach due to market forces (e.g., rise in commodity prices) or the State's conduct.

[32] Canada-Costa Rica BIT (1998), Article XII (2); China-Korea BIT (2007), Article 9(1); US Model BIT (2004), Article 24 (1); Investment Agreement for the COMESA Common Investment Area (2007), Article 28 (1); CETA, Article 8.18; Canada 2021 Model FIPA, Article 40 (5).

[33] See India Model BIT (2003), Article 23 (2).

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35. Article 31 of the ILC Articles states that the injury needs to be "caused by" an internationally wrongful act. According to the commentary, the causal connection between the breach of an agreement and the loss claimed must not be too speculative, remote, or uncertain. There are numerous terms used to describe the link, which must exist between the wrongful act and the injury in order for the obligation of reparation to arise.[34] The terms generally used are remoteness, directness, proximity and foreseeability. The ILC Articles do not express a preference for a specific legal test of causation,[35] but notes that the requirement of a causal link is not necessarily the same in every breach of an international obligation.[36]

3. Burden and standard of proof

36. As a generally accepted principle of law, the party that relies on a fact bears the duty to prove it.[37] Accordingly, regarding damages, the investor generally bears the burden of proof regarding the amount of loss and the causality, whereas the respondent State bears the burden of proof regarding its defences, such as circumstances limiting the causality or the amount of loss.[38]

37. Most arbitration rules are silent on the subject of standard of proof and usually grant arbitral tribunals a wide discretion in evaluating evidence. For instance, Article 27(4) of the UNCITRAL Arbitration Rules and Article 9(1) of the IBA Rules both express that the arbitral tribunal shall determine the admissibility, relevance, materiality and weight of the evidence offered. Rule 36(1) of the 2022 ICSID Arbitration Rules also states that "the Tribunal shall determine the admissibility and probative value of the admissibility of the evidence adduced".

38. Article 36(2) of the ILC Articles clarifies that compensation shall cover damage that is financially assessable and established. For lost profits, the commentary to the ILC Articles indicate that they have often been awarded when the anticipated future profits have attained attributes to be considered a legally protected interest of sufficient certainty. The commentary further indicate that the probability of anticipated future profits must be demonstrated with sufficient documentary or other appropriate evidence, which might be achieved through contractual arrangements or a well-established history of dealings.[39]

4. Awarding interest and how to calculate interest

39. Interest forms an integral part of compensation. Given the length of ISDS proceedings, interest can constitute a significant portion of the overall compensation and is therefore of eminent economic importance.[40]

40. Interest compensates the claimant for the loss of the use of its money; fully compensates the claimant by restoring it to the position it would have enjoyed had the breach not occurred.

41. However, the general principle of full reparation does not define all the necessary elements for calculating interest, particularly the interest rate and whether the interest should be compounded, both of which impact the amount of interest to be awarded.

42. Some investment treaties mention interest in the context of expropriation and indicate that interest should be granted "at a commercially reasonable rate" or a slight

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[34] ILC commentary on Article 31, para. 10.
[35] Marboe, Damages, pp. 39–86.
[36] Supra note 34.
[37] See Article 27(1) of the UNCITRAL Arbitration Rules and 2022 ICSID Arbitration Rules, Rule 36(2).
[38] Beharry/Bräutigam, p. 7.
[39] ILC commentary on Article 36, para. 27.
[40] Interests constitute on average 24% of the value of an award, and in several cases, the amount of interest awarded even exceeded the amount of damages, see PWC Study 2016, p. 1.

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variation thereof,[41] accruing from the date of expropriation to the date of payment. Some treaties foresee interest as compensating for damages resulting from acts other than expropriation.[42] However, the treaties usually do not address the question of simple versus compound interest and of accruing intervals.

43. Article 38 of the ILC Articles addresses the issue of interest but similarly remains silent beyond its standard that "the interest rate and the mode of calculation shall be set so as to achieve that result." Regarding the period over which interest is to run, Article 38 states that the period runs "from the date when the principal sum should have been paid until the date the obligation to pay is fulfilled."

(a) Pre-award rate

44. Once the valuation date is decided, tribunals determine the pre-judgement interest rate. Tribunals often apply an interbank rate, as it would result in more objective and predictable outcomes as compared to a rate based on the creditworthiness of an individual investor. Tribunals also frequently apply an additional premium to the interbank rate to reflect a market value of money in a specific currency. Other options for an applicable interest rate could include the bank deposit interest rate, the "risk-free" rate, the weighted average cost of capital (WACC), the regulatory return on investment, the cost of debt rate, the absolute value (e.g. statutory rates), and the contractual rate, some of which are rarely used.

(b) Post-award interest – potentially higher rates

45. Post-award interest is determined primarily based on three factors: (i) preservation of the fair market value of the award; (ii) compensation for the risks in collecting the award, including any risk of default; and (iii) desire to disincentivize delay in payment and using the award as a source of inexpensive financing.

46. In determining post-award interest rates, ISDS tribunals have taken different approaches with regard to the starting date from which post-award interest is to run, the interest rate to be applied, and the mode of calculation. While post-award interest normally runs from the date of the award, some tribunals have opted for a grace period to enable parties to take the necessary internal steps to arrange for payment. Additionally, a few tribunals have chosen to apply a higher rate for post-award interest to discourage delays in payment. Following the same rationale, some tribunals have chosen to compound only post-award interest or to adopt a shorter compounding frequency for post-award interest.[43]

(c) Simple or compound interest

47. Another aspect in calculating the amount of interest involves the choice between simple or compound interest, as well as the selection of intervals at which interest is to accrue.

48. Tribunals have increasingly awarded compound interest.[44] According to a study, the ratio of ISDS tribunals awarding compound interest was 50% before 2005, but in between 2011 and 2015, that rose to 87%.[45] It is mainly the payment of compound

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[41] Such variations include "at a normal commercial rate" (CETA, Article 8.12(3)) and "at a rate determined according to market criteria" (Brazil-India BIT 2020, Article 6.2)). In other cases, treaties substantively articulate beyond "a commercially reasonable rate" (Cabo Verde–Hungary BIT 2019, Article 6.3.)

[42] See e.g., Cabo Verde–Hungary BIT 2019, Article 5.2.

[43] Beharry/Bräutigam, p. 30.

[44] Ibid., pp. 29, 30.

[45] PWC Study 2016, p. 2.

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interest that results in extremely large awards of interest, which can even exceed the principal sum.[46]

49. In many national legal systems, compound interest is not allowed, and the commentary on Article 38 of the ILC Articles suggest that absent a compelling reason to award compound interest, an award of simple interest is more appropriate.[47] The proponents of compound interest claim that the award should reflect the sophistication of businesses engaging in transnational commerce in modern times. They further contend that an award of compound interest is appropriate when the respondent's failure to fulfil its obligations in a timely manner causes the claimant either to incur financial charges that include compound interest or to forego opportunities that would have had a compound effect on its investment.

50. Regarding the accruing intervals, ISDS tribunals often consider the period over which interest is to run and the intervals at which interest is to accrue as separate questions. For example, tribunals may choose to order that interest be compounded annually, within a six-month period or, conversely, that interest be compounded semi-annually for one year. ISDS tribunals have reduced the compounding frequency when the resulting absolute amount of interest was too high,[48] while other tribunals had determined that the compounding frequency should be increased due to the length of time during which the claimant had been without compensation.[49]

5. Role of experts

51. With respect to the quantification of compensation, parties generally seek the assistance of experts. The choice and application of a methodology, as well as the calculation of compensation, often require specialised and technical knowledge, in particular where the valuation method requires in-depth information about the industry or the practice.

52. A number of arbitration rules provide for the participation of expert(s) in arbitral proceedings and recognise party- and tribunal-appointed experts. The UNCITRAL Arbitration Rules explicitly provide for both types of experts.[50] The ICSID Arbitration Rules foresee that parties could rely on evidence given by an expert and that the tribunal may appoint one or more independent experts.[51] While ISDS tribunals have the discretion to appoint their own experts, they seldom do so.[52]

53. The IBA Rules also address the issue of party- and tribunal-appointed experts. Article 5.2(e) provides that the expert report must include "a description of the methods, evidence and information used at arriving at the conclusion," so that the other party and the tribunal may meaningfully evaluate the report. Furthermore, the expert report must contain a statement of the expert's independence. Article 5.4 of the IBA Rules allows the tribunal to order the party-appointed experts who have submitted reports on similar issues to meet and discuss these reports and to present joint reports, in order to determine areas of agreement and disagreement. This may make the proceedings more economical, as experts from the same discipline can identify in a relatively quick manner the reasons for their diverging conclusions and find areas of agreement.[53]

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[46] See for example the case: *Compania Del Desarrollo De Santa Elena, S.A. v. Costa Rica:* 4.15 million USD in principal damages, and 11.85 million USD in interest award, based on a rate that was compounded semi-annually (as opposed to 5.7 million USD, if the tribunal had awarded simple interest), see paras. 85 and 107, available at http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C152/DC539_En.pdf.

[47] ILC commentary on Article 38, paras. 8–12.

[48] PWC Study 2016, p. 5.

[49] See Gotanda, p. 394.

[50] See articles 27(2) and 29.

[51] See Rules 38 and 39.

[52] However, ICSID recently noted that tribunal-appointed experts are being increasingly used.

[53] Commentary on the revised text of the 2010 IBA Rules on the Taking of Evidence in International Arbitration, p. 20.

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6. Other factors limiting the amount of compensation

54. States can have recourse to defences to avoid being in breach of a treaty obligation. For example, the state of necessity refers to a situation where the sole means of preserving an essential national/public interest threatened by a grave and imminent peril is to adopt measures inconsistent with their obligations under investment treaties.[54]

55. There may be instances where an action or a non-action by the investor would need to be taken into account in calculating the amount of compensation as outlined below. One would be when the investor is at fault and the other would be when the investor did not take the appropriate action to mitigate the losses. There may be other factors that would limit the amount of compensation.[55]

(a) Contributory fault

56. Although investment treaties generally do not address this issue, the amount of compensation may be reduced if the claimant's own conduct contributed to the loss that it suffered. This is in line with the principle that the injured party shall be awarded full reparation, but not more than the damage caused by the other party.

57. The notion of contributory fault is reflected in Article 39 of the ILC Articles, which stipulates that a "contribution to the injury by wilful or negligent action or omission of the injured" party shall be taken into account in the determination of reparation. The same principle is expressed in other areas of law (such as in Article 80 of the Vienna Convention on the International Sale of Goods ("CISG") or Article 7.4.7 of the UNIDROIT Principles for International Commercial Contracts ("UNIDROIT principles")).

58. ISDS tribunals have recognised the notion of contributory fault when awarding compensation.[56] Contributory fault can include violation of the State's domestic law[57] and the increase of loss by the investor, for example as a result of the business risk.[58] Tribunals generally have the discretion to determine the extent to which the investor's contributory fault will affect the amount of compensation.[59]

(b) Failure to mitigate losses

59. The principle of mitigation expresses the duty of the injured party to take reasonable steps to reduce the loss caused by the breaching party. If the injured party fails to do so, it will not be able to recover the portion of the loss attributable to its failure to mitigate the damages.

60. The principle of mitigation is widely recognized in different areas of law, as reflected in Article 77 of the CISG and Article 7.4.8 of the UNIDROIT principles. In a decision concerning the recovery of lost profits, the Governing Council of the United Nations Compensations Commission recognised the claimant's duty to

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[54] Beharry/Bräutigam, p. 25; Under article 27 of the ILC Articles, the state of necessity precludes the wrongfulness of the States conduct, however compensation might be awarded. Several investment treaties provide for the defense of necessity, which is meant to excuse a breach.

[55] Additional factors limiting compensation include prior damages or compensation received for the same loss, and the restitution of property or the repeal or modification of the measure which incurred the breach.

[56] See *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7 (MTD v. Chile); *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador*, ICSID Case No. ARB/06/11 (Occidental v Equador); *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL, PCA Case No. 2005-04/AA227 (Yukos v Russia).

[57] See *Occidental v Equador*; *Yukos v Russia*; *Copper Mesa v. Ecuador Copper Mesa Mining Corporation v. Republic of Ecuador*, PCA Case No. 2012-2.

[58] Kantor, p. 535; *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7.

[59] *Occidental v Equador*; Kantor, p. 540.

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mitigate losses whenever possible.[60] Accordingly, a claimant is not only permitted but also obliged to take the necessary steps to mitigate the loss.

61. The commentary on Article 31 of the ILC Articles also address the mitigation of damages, clarifying that it is not a legal obligation which gives rise to responsibility, but that a failure to mitigate may preclude recovery to that extent.[61]

62. The duty to mitigate and its limiting effect on recoverable damages have been accepted by ISDS tribunals as a principle of international law. As to the extent of the duty to mitigate damages, tribunals have consistently held that the injured party must meet a duty of best efforts and take reasonable and prudent steps to minimalize the loss.[62]

C. Matters for consideration and possible work

63. The Working Group may wish to consider whether it would be desirable to undertake work for example, by (i) developing relevant provisions, possibly with a binding effect, on procedural issues related to the assessment of damages and compensation to be included in investment treaties, arbitration rules or a multilateral instrument on procedural reform; and (ii) developing guidelines and standards to be provided to ISDS tribunals on the topic.

1. Complexity and uncertainty of current practice

64. As shown in section B, the current practice of assessment of compensation shows a high degree of complexity, which may partially be due to the lack of regulation of the main parameters of damage calculation as well as different factual circumstances. This complexity contributes to increase in costs of ISDS proceedings and may negatively impact the correctness,[63] consistency[64] and predictability of awards related to the calculation of compensation.[65]

Possible areas of work

65. The Working Group may wish to consider preparing draft treaty provisions, or guidelines on the following issues:

- The compensation standard, in particular for cases of illegal expropriation and non-expropriatory breaches;
- The valuation method (including whether the DCF method is appropriate and including the use of sensitivity analysis or alternative assumptions);
- The valuation date;
- Conduct of the claimant, which would limit the amount of compensation;
- Causation between the breach and the loss;
- Evidentiary requirements, including the standard of proof;
- Pre- and post-award interests (the interest rate, the mode of calculation and whether to compound the interest);
- The appropriateness of requests for tax gross-ups to increase the amount of the award based on the assumption that tax will be collected on it;
- Potential role of national bodies and domestic law in the calculation of damages;

[60] Decision 15 of the UNCC Governing Council dated 18 December 1992.
[61] ILC commentary on Article 31, para. 11.
[62] Beharry/Bräutigam, p. 24.
[63] See the Academic Forum paper, section 4.2.
[64] Ibid, section 4.1.
[65] See, for example IISD, p. 30; BIICL study, pp. 26, 29.

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- Role of experts in assessing damages including means of appointment and their ethical regime; and
- Allocation of costs where various factors might be considered such as the outcome of the case, the parties conduct, the reasonableness.[66]

2. High amounts of compensation and increased amount of claims

66. The Working Group may wish to consider whether to address the issue of high and increasing amounts of compensation claimed by investors in ISDS proceedings and awarded.

67. As of August 2019, there were 44 known awards with a value of 100 million USD or more, and 9 awards over 1 billion USD.[67] From the first case in 1981, it took 21 years of cumulative awards of damages to grow to 10 billion USD. In 2006, the cumulative amount had doubled reaching 20 billion USD and, 4 years later, the amount doubled again reaching 40 billion USD in 2010.[68]

68. Moreover, commentators have noted that the amounts awarded often vastly exceed the investors' expenditures on the investment, and that neither the benefit of the investment for the host State nor the investor's misconduct, such as breach of human rights, is taken into consideration when calculating compensation.[69]

Possible areas of work

69. The Working Group may wish to consider whether to develop draft treaty provisions or guidelines to be followed by ISDS tribunals regarding:

- The use of valuation methods, including the appropriate discount rate to be applied to calculations with the DCF method and calculation of interest;
- The capping of compensation, for instance to the amount actually invested by the investor; and
- Contextual factors, such as the host States' ability to pay for the amounts awarded, the potential "crippling effect" of an award on the respondent State, and the benefits of the investment to the State's sustainable development goals.[70]

3. Means to address discrepancy between claimed loss and awarded damages, including excessive claims

70. The Working Group may wish to consider the significant divergence between the amount of compensation claimed and the compensation awarded.

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[66] See also A/CN.9/WG.III/WP.219, Section C.

[67] See also IISD, p. 29.

[68] The Hart/Velez Study, p. 13 concludes that the amount of the claims in recent years seems to be stabilizing, albeit at a high level. The Academic Forum paper refers to different data and studies, all of which show a significant increase over the last decades. For example, based on UNCTAD/ITALAW data, the median amount of awards between 1990-1999 amounted to 2 million USD, between 2000–2009 to 16.7 million USD and between 2010–2019 to 32.9 million USD, see section 2.2. Based on PluriCourts Investment Arbitration Database (PITAD), the median amount of awards between 1980–1999 amounted to 4.2 USD million, between 2000–2009 to 21.3 million USD and between 2010–2019 to 27.8 million USD, see section 2.3. The median amount is not the average amount, but a middle value which is not impacted by extremely small or large amounts awarded.

[69] The Netherlands Model Investment Agreement (2019) provides in Article 23 that tribunals may in their decision on the amount of compensation take into account "non-compliance by the investor with its commitments under the UN Guiding Principles on Businesses and Human Rights, and the OECD Guidelines for Multinational Enterprises."; See also C. Baltag (Editor), 'Human Rights and Environmental Disputes in International Arbitration', Kluwer Arbitration Blog, July 24 2018, http://arbitrationblog.kluwerarbitration.com/2018/07/24/humanrights-and-environmental-disputes-in-international-arbitration/.

[70] IISD, p. 31; See also M. Paparinskis, A Case Against Crippling Compensation in International Law of State Responsibility, The Modern Law Review, Volume 83, Issue 6 (November 2020).

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71. A study calculated that the average claims amounted to 910.6 million USD against an average award of 298.3 million USD.[71] Accordingly, investors claim on average three times the amount they are actually awarded. In a different study, after the exclusion of three outlier cases, the average amount claimed was 275.3 million USD, with the average compensation awarded amount being 55.2 million USD.[72] On this basis, investors claim on average five times the amount they are actually awarded.

Anchoring effect and cost allocation

72. The so-called "anchoring effect" was discussed as a potential reason for the growth in large damage awards. [73] It was based on the observation that investors tend to make exaggerated claims as a legal tactic, thereby counting on a possible cognitive bias of tribunals where exaggerated claim are used as a basis for the calculation of compensation.[74]

73. The Working Group may wish to consider whether manifest over-statements of the amount of damages could be addressed through the allocation of cost (see A/CN.9/WG.III/WP.219). For example, the claimant may be required to bear a higher fraction of the costs if the damages claimed exceeded a certain percentage of the actual loss.[75]

4. Divergence of expert damage calculations

74. Another cause of the discrepancy in assessment of damages claimed and compensation awarded may be the wide divergence in compensation amounts presented by the parties' experts.[76]

75. A study found that such divergence on experts' results is partly due to the fact that experts are instructed by counsels and answer to different questions potentially based on different factual or legal assumptions, and treat factual issues differently as they genuinely have different opinions. Quality concerns were non mentioned as a frequent concern[77].

Possible areas of work

76. The Working Group may wish to consider whether to undertake work on preparing draft treaty provisions or guidelines[78] on the appointment of experts to assist the tribunals in calculating damages. This might strengthen the impartiality and independence of expert on damages. This approach might further alleviate the overall costs of the proceedings, part of it which derive from the increasing costs of experts.

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[71] Hart/Velez Study, p. 7; The BIICL study came to the following conclusion: "When the amount of damages claimed is compared with the amount of damages awarded, one sees a modest increase in the amount of damages awarded out of the amount claimed, from a median percentage of 29% before June 2017 to 36% in the past three years.", p. 28.

[72] A study analysing 241 awards found that "damages awarded total almost 71.91 billion USD on claims of over 219 billion USD, which results in an average award as a percentage of claim amount of 32.8%". However, the average amount awarded was 298.3 million USD with the average claim amounting to 910.6 million USD. See Hart/Velez Study, p. 7.

[73] See Swinehart, p. 310.

[74] A/CN/9/WG.III/WP.156 paras. 8–9.

[75] IISD, p. 25; see Colombia Model BIT (2017), p.21, which provides that if the estimated amount of damages identified by the claimant exceeds the proven amount by fifty% or more, the tribunal shall allocate fifteen% of the resulting difference as costs in favour of the respondent.

[76] PWC Study 2015, p. 2: the amount quantified by respondents' experts was on average 13% of the amount quantified by claimants' experts; see also Beharry, p. 3–8.

[77] Ibid., p. 2 and 5.

[78] Such work could benefit from existing instruments, for example, the Protocol on Determination of Damages in Arbitration by CPR International Committee on Arbitration.

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77. Alternatively, guidelines could be developed for party-appointed experts which would:

- Ensure that experts work on the basis of a harmonized, clearly defined set of instructions based on similar assumptions;
- Require alternative calculations in cases of disagreement on facts and legal approaches;
- Require a joint statement by the experts explaining the differences in case the results of the expert opinions differ; and
- The teaming up of party-appointed experts to issue a joint report and the right of tribunals to direct experts.

D. Interrelation with other reform options

78. The Working Group may wish to consider that the topic of damages and compensation is closely linked with the following reform options:

- Early dismissal of speculative, unsubstantiated, and inflated claims (A/CN.9/WG.III/WP.219);
- Regulation of third-party funding to address high amount of compensation claimed (A/CN.9/WG.III/WP.219);
- Appellate and multilateral standing mechanisms to address procedural and substantive correctness of decisions and to rectify errors in decisions by ISDS tribunals (A/CN.9/WG.III/WP.185);
- Means to address regulatory chill; and
- Means to address multiple proceedings including on shareholder claims and reflective loss (A/CN.9/WG.III/WP.170; and A/CN.9/WG.III/WP.193).

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