

## Possible reform of investor-State dispute settlement (ISDS)

### Assessment of damages and compensation

#### Note by the Secretariat

#### Contents

I.	Introduction .....	2
II.	Assessment of damages and compensation in ISDS .....	3
A.	Background information .....	3
B.	Existing legal framework .....	4
1.	Lawful expropriation .....	4
2.	Unlawful expropriation .....	5
3.	Breaches of other treaty standards .....	6
C.	General Issues .....	6
1.	Valuation methodology .....	6
2.	Causation .....	9
3.	Evidentiary Requirements .....	9
4.	Interest .....	10
5.	Role of Experts .....	11
6.	Factors limiting the amount of compensation .....	12
D.	Matters for consideration and possible work .....	13
1.	The complexity and uncertainty of the current practice .....	13
2.	Valuation methods, including calculation of interest .....	14
3.	Discrepancy between compensation claimed and awarded .....	15
4.	Divergence of expert damage calculations .....	16
E.	Interrelation with other reform options .....	16

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## I. Introduction

1. At its thirty-fourth to thirty-seventh sessions, the Working Group undertook work on possible reform of ISDS, based on the mandate given to it by the Commission at its fiftieth session, in 2017.<sup>1</sup> At those sessions, the Working Group identified and discussed concerns regarding ISDS and considered that reform was desirable in light of the identified concerns, while reiterating that other concerns could be identified and dealt with at a later stage of the deliberations (A/CN.9/970, para. 39).
2. At its thirty-eighth session, the Working Group requested the Secretariat to consider how possible work on damages and compensation could be undertaken (A/CN.9/1004, para.104).<sup>2</sup>
3. Accordingly, this Note aims to outline the key issues relevant to the question of assessment of damages and the determination of compensation<sup>3</sup> in ISDS, including underlying legal principles and methodologies (A/CN.9/1004, para. 102).
4. As is the case for other documents provided to the Working Group, this Note was prepared with reference to published information on the topic,<sup>4</sup> and does not seek

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<sup>1</sup> *Official Records of the General Assembly, Seventy-second Session, Supplement No. 17 (A/72/17)*, paras. 263-264. The deliberations and decisions of the Working Group at the thirty-fourth to thirty-seventh sessions are set out in documents A/CN.9/930/Rev.1 and its Addendum, A/CN.9/935, A/CN.9/964, and A/CN.9/970, respectively.

<sup>2</sup> The deliberations and decisions of the Working Group at the thirty-eighth session are set out in document A/CN.9/1004. Document A/CN.9/WG.III/WP.166 provides an overview of reform options.

<sup>3</sup> The terms “damage” and “compensation” are used in this paper following the terminology of the International Law Commission’s Draft Articles on Responsibility of States for Internationally Wrongful Acts (“ILC Articles”), which refers to “damage” in the sense of a harm or loss and “compensation” as the generic term for monetary sums payable for a harm to the affected party.

<sup>4</sup> This Note was prepared with reference to a broad range of published information on the topic, including: C. L. Beharry, ed., *Contemporary and Emerging Issues on the Law of Damages and Valuation in International Investment Arbitration* (Leiden, The Netherlands, Brill, 2018) (“Beharry”); 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, D. Behn, Damages and ISDS Reform: Between Procedure and Substance (to be published soon, 2021) (“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*, pp. 394; 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”); International Law Commission Draft Articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001 (ILC Articles and Commentaries), available at: [https://legal.un.org/ilc/texts/instruments/english/commentaries/9\\_6\\_2001.pdf](https://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf); J.E. Kalicki and A. Joubin-Bret, *Reshaping the Investor-State Dispute Settlement System*, Nijhoff International Investment Law Series, Band: 4 (BRILL, 2015); R. Knieper, *Rethinking Investment Arbitration* (München, SchiedsVZ, 2015), pp. 25-32, P. Muchlinski, F. Ortino, and 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, A Scoping Paper for the Investment Policy Community, D. Gaukrodger, K.Gordon, available at [http://www.oecd.org/investment/investment-policy/WP-2012\\_3.pdf](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-arbitration-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

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

## II. Assessment of damages and compensation in ISDS

### A. Background information

5. At its thirty-fourth session, 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).

6. When the Working Group considered other potential concerns at its thirty-seventh session, the high amount of compensation awarded by arbitral tribunals was mentioned as one of the elements that undermine States' ability to regulate. Assessment of damages and compensation was therefore raised as a topic warranting consideration (A/CN.9/970, paras. 36-38).

7. At the thirty-eighth session of the Working Group, 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). Concerns were also expressed regarding the impact of third-party funding on the amount of compensation claimed (A/CN.9/1004, para. 80).

8. Moreover, several submissions received from Governments ("Submissions") raise the issue of damages and the determination of compensation.<sup>5</sup> In these Submissions, the inconsistency and unpredictability of awards on damages are underlined.

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<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](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); M. Kantor, *Valuation for Arbitration: Compensation Standards, Valuation Methods and Expert Evidence* (Kluwer Law International, 2008); 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"); J. 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; 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; 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>.

<sup>5</sup> The following Submissions refer to damages: A/CN.9/WG.III/WP.156, Submission from the Government of Indonesia; A/CN.9/WG.III/WP.159/Add.1, Submission from the European Union and its Member States; A/CN.9/WG.III/WP.173, Submission from the Government of Colombia; A/CN.9/WG.III/WP.175, Submission from the Government of Ecuador; A/CN.9/WG.III/WP.176, Submission from the Government of South Africa, A/CN.9/WG.III/WP.182, Submission from the Governments of Chile, Israel, Japan, Mexico and Peru, A/CN.9/WG.III/WP.199, Submission from the Government of Burkina Faso.

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9. One Submission notes that claimants tend to claim exaggerated compensation “in the hope that a less exaggerated but still indefensible amount will seem reasonable by comparison”.<sup>6</sup> The Submission refers to the large gap between claimants’ and respondents’ valuations of damages, which requires a clear valuation method in order to curb the risk of abuse.<sup>7</sup> Another Submission refers to the “vast differences between the amounts invested and the amounts awarded as compensation” and to the fact that arbitral tribunals “generally do not take contextual factors into account” and stress that the high amounts awarded could result in a “regulatory chill”.<sup>8</sup>

10. A further Submission underlines that guidelines on compensation should contain a “check-and-balances mechanism for claims, an established method for the valuation of businesses in accordance with internationally recognized standards in financial reporting, a code of conduct for arbitrators in appraising such valuation, and a mechanism to dismiss frivolous claims at an early stage.”<sup>9</sup>

11. Another Submission suggests the adoption of objective and transparent criteria for determining the compensation payable to investors that have suffered damage and emphasizes that it is important that the amount of compensation is commensurate with the actual damage suffered.<sup>10</sup>

## **B. Existing legal framework**

12. Investment treaties generally provide for substantive guarantees and standards, such as protection against expropriation, fair and equitable treatment (FET), and non-discrimination, and foresee that investors can claim compensation in case of a breach of these treaty obligations.

13. While compensation standards for lawful expropriatory breaches are regularly contained in investment treaties, awards for the compensation of damages resulting from unlawful expropriation and breach of other treaty obligations are both usually derived from the principle of full reparation under customary international law.<sup>11</sup>

### **1. Lawful expropriation**

14. Investment treaties generally foresee compensation as a condition for lawful expropriation, which needs to be conducted in accordance with due process, for a public purpose, and in a non-discriminatory manner.<sup>12</sup> It is generally agreed that such compensation shall be equivalent to the fair market value of the expropriated investment before the expropriation took place (or before it became known),<sup>13</sup> that the payment shall be made without delay, and that it shall include interest.<sup>14</sup>

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<sup>6</sup> Submission from the Government of Indonesia, [A/CN.9/WG.III/WP.156](#), paras. 8-9.

<sup>7</sup> Ibid.

<sup>8</sup> A/CN.9/WG.III/WP.199, Submission from the Government of Burkina Faso, paras. 7, 9 and 10.

<sup>9</sup> Submission from the Government of Indonesia, [A/CN.9/WG.III/WP.156](#), paras. 8-9; see also Submission from the Government of South Africa, [A/CN.9/WG.III/WP.176](#), para. 73.

<sup>10</sup> Submission from the Government of Morocco, [A/CN.9/WG.III/WP.161](#), para. 14; see also A/CN.9/WG.III/WP.199, Submission from the Government of Burkina Faso, para.11.

<sup>11</sup> See also the statistical survey information in OECD Working Paper, p. 29.

<sup>12</sup> See, for instance, Japan - Morocco BIT (2020), Article 9; Brazil - India BIT (2020), Article 6.

<sup>13</sup> National legal frameworks on expropriation are usually more restrictive with respect to compensation.

<sup>14</sup> 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; TPP (2016), Article 9.8; Energy Charter Treaty (1994), Article 13).

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15. Certain investment treaties add elements to the standard of fair market value,<sup>15</sup> while others refer to a different standard and include contextual factors.<sup>16</sup>

## **2. Unlawful expropriation**

16. Compensation for unlawful expropriation is generally not dealt with in investment treaties and differing opinions have been expressed on the applicability of the standard for lawful expropriation. While some argue that the standard for lawful expropriation is to be applied to unlawful expropriations, others refer to the full reparation standard referred to under the International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts ("ILC Articles").<sup>17</sup> The ILC Articles are not binding on States but are well recognized and broadly applied by ISDS tribunals.<sup>18</sup>

17. Moreover, compensation standards do not differentiate between direct and indirect expropriation. Indirect expropriation, which can be described as the total or near-total deprivation of an investment without a formal transfer of title or outright seizure,<sup>19</sup> may however require a different compensation standard in order to take into account its particularities, i.e. the possibility of a continued operation of the "expropriated" investment.

### **a. Full reparation standard**

18. The principle of "full reparation" finds its origin in a judgment of the Permanent Court of International Justice (PCIJ) rendered in 1928 in the case *Factory at Chorzów*, where the Court decided that the compensation must wipe out the consequences of a State's "illegal acts".<sup>20</sup> Subsequently, the principle has been 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.<sup>21</sup>

### **b. Restitution or compensation**

19. "Wiping out" the consequences of a wrongful act requires: (i) a comparison of the current and real situation after the wrongful act with the hypothetical situation but for the wrongful act; and (ii) an effective remedy. Article 34 of the ILC Articles provides for three forms of remedy: restitution, compensation, and satisfaction. The *Chorzów* case highlights the primacy of restitution, under the caveat that restitution is

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<sup>15</sup> For instance, by providing that valuation criteria for the determination of the fair market value should include going concern value, asset value, asset value including the declared tax, such as value of tangible property, and other criteria as appropriate (see, for instance NAFTA (1994), Article 1110(2); EU - Singapore Investment Protection Agreement (2018), Article 2.6).

<sup>16</sup> By providing for fair and adequate compensation and specifying that 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)).

<sup>17</sup> Beharry/Bräutigam, *Damages and Valuation in International Investment Arbitration*, pp. 11- 12.

<sup>18</sup> The ILC Articles have been drafted in 2001 and have most 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>).

<sup>19</sup> UNCTAD Series on International Investment Agreements II, *Expropriation, A Sequel* (New York, 2012), p. 7.

<sup>20</sup> *Factory at Chorzów, Germany v Poland, Judgment, Claim for Indemnity, Merits, Judgment No 13, (1928) PCIJ Series A No 17, ICGJ 255 (PCIJ 1928)*, 13th September 1928, League of Nations (historical) [LoN]; Permanent Court of International Justice (historical) [PCIJ].

<sup>21</sup> Article 31 reads as follows: "Reparation (1) The responsible State is under an obligation to make full reparation for the injury caused by the inter-nationally wrongful act. (2) Injury includes any damage, whether material or moral, caused by the internationally wrongful act of a State."

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practicable, and so does Article 35 of the ILC Articles by foreseeing compensation only in cases of impossibility or unproportionality of restitution.<sup>22</sup>

20. Decisions on investment treaty disputes have, however, shown a *de facto* primacy of compensation over restitution. The application of principles of commercial arbitration in ISDS might have contributed to this development, as well as respect for the sovereignty of a State, which should not be ordered to perform specific conduct but rather to compensate as a less intrusive remedy into internal affairs. However, some commentators have noted that awarding large amounts of compensation may create equally serious challenges to States and be as intrusive into States' sovereignty as ordering a certain type of conduct.<sup>23</sup> In addition, in other areas of economic law, the tendency has been towards performance rather than compensation.<sup>24</sup>

### 3. Breaches of other treaty standards

21. Where treaties provide no guidance, tribunals generally also apply the principles outlined in the *Chorzow* decision and the ILC Articles related to compensation for other breaches, such as breaches of the FET or the "full protection and security" standard.

22. However, the application of these compensation standards has proven to be problematic, where the investor has not been permanently and fully deprived of title, the property's economic value, or when the investor has continued to operate its investment but with reduced return on investment or when the ability to use or control the property in a meaningful way has not been impaired.<sup>25</sup>

23. Some recently concluded investment treaties include provisions on damages, by (i) excluding certain types of compensation, such as compensation for punitive damages;<sup>26</sup> (ii) prescribing limitations on the compensation that may be awarded, by providing that the compensation awarded shall not be greater than the loss suffered by the investor and should be reduced by any prior compensation already provided;<sup>27</sup> (iii) limiting the compensation if the investment did not materialise; (iv) requiring that the breach has a sufficiently close nexus to the harm;<sup>28</sup> or (v) otherwise providing for a number of mitigation factors in the calculation of compensation.<sup>29</sup>

## C. General Issues

### 1. Valuation methodology

24. There are various methodologies to calculate the amount of compensation. Neither customary international law nor treaty-based standards require the application

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<sup>22</sup> Article 34 of the ILC Articles also 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."

<sup>23</sup> Schreuer, pp. 1059 - 1060.

<sup>24</sup> The WTO system, for example, does not foresee any monetary compensation, but only the performance of specific acts.

<sup>25</sup> Beharry/Bräutigam, pp. 14-15.

<sup>26</sup> Canada-EU (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.

<sup>27</sup> See e.g. Netherlands Model BIT (2019), Article 22 (3): An award can only result in compensation for damages, unless the disputing parties agree on restitution. Monetary compensation shall include the applicable interest at a normal commercial rate from the date of expropriation until the date of payment. (4): The Tribunal shall not award punitive damages. Monetary damages shall not be greater than the loss suffered by the investor, reduced by any prior damages or compensation already provided in relation to the same factual dispute. For the calculation of monetary damages, the Tribunal shall also reduce the damages to take into account any restitution of property or repeal or modification of the measure. See also EU-Singapore Investment Protection Agreement (2018), Article 3.18; EU-Viet Nam Investment Protection Agreement (2019), Article 3.53; Canada - EU (CETA, 2016), 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.

<sup>28</sup> TPP (2016), 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. (...)"

<sup>29</sup> See Indian Model BIT (2015), Article 26.3; see also India-Belarus BIT (2018), Article 26.3.

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of a particular valuation methodology, leaving the choice to the discretion of the tribunal.<sup>30</sup>

25. The methods used by ISDS tribunals to determine the quantum can be broadly grouped into forward-looking and backward-looking approaches.

**a. Backward-looking approaches**

*Asset-based approaches*

26. The asset-based approaches use either the book value or the replacement value of the expropriated assets. The book value looks to the difference between total assets and total liabilities, whereas the replacement value is the amount an entity would have to pay to replace the asset at stake.

*Historical approach*

27. The historical approach makes reference to the invested amount that the initial investor spent to build the investment.

**b. Forward-looking approaches**

28. The forward-looking approaches, i.e. the income and the market-based approaches, seek to capture expected investment returns and to predict how the future investment would have developed but for the wrongful act of the State. By analysing how much a willing buyer would be ready to pay for the disputed investment, these approaches acknowledge that the value of a business is based on its ability to generate profits.

*The market-based approach*

29. The market-based approach compares the disputed business' interest with the value of similar businesses on the market to determine what a hypothetical buyer would have been willing to pay for the business/assets before the violation.<sup>31</sup> This method requires the availability of comparable data, which may raise issues as the investments at stake are often unique with no comparable businesses or assets on the market.

*Income-based approaches*

30. Income-based approaches attempt to convert anticipated economic benefits into a present value. It can refer to any of the following three methods: (i) the discounted cash flow ("DCF"); (ii) adjusted present value; and (iii) capitalised cash flow. The DCF analysis, which is currently the most common valuation method, aims to calculate the present value of future expected cash flows to capture future profits or returns. It does so by estimating future streams of free cash flows and then discounting the amount by a rate which incorporates the risks and the passage of time.

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<sup>30</sup> Using different valuation methods could lead to very different results for cases based on comparable facts. 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 arbitral 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.

<sup>31</sup> The US Private Equity Industry Guidelines Group (PEIGG) recommends that managers of investments in private equity portfolios look first to valuation methods within the market-based approach.

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**c. Choice of valuation method**

31. An appropriate valuation method depends on a number of factors, including whether the investor is facing a full and permanent loss of the investment or only a partial loss for a determined period of time, the diminution of the investment's value over time or a reduction on the expected return on investment, or the loss of only invested amounts. Further, the approach adopted by ISDS tribunals might depend on the business involved. For example, asset-based approaches have been considered appropriate where the business value was derived largely from its underlying value and not from its earnings.

32. The approach to be adopted might also depend on past performance, a going concern. In cases in which a business enterprise can demonstrate through past performance that it has a likelihood of earning profits in the future as well, the DCF model has been applied. In other cases where investments have no firmly established income-producing capacity and no past records of profitability, the calculation of future profitability have involved a higher degree of uncertainty, while the backward-looking asset-based approaches and the historical approach have the benefit of providing greater certainty regarding the values.

**d. Challenges of the DCF method**

33. 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.<sup>32</sup> 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, competitive forces, and industry outlook. The application of the DCF method for non-operating assets, businesses with a limited history of operations, and the availability of market-generated information (especially when the investment is unique) can be problematic.<sup>33</sup>

34. 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, according to a study, a significant source of disagreement.<sup>34</sup> To forecast future investment returns, 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 operative expenditures, additional capital requirements, and other elements. The difficulty of correctly estimating these values and the risk of speculation increases if the timeframe for which projections are made increases.

35. Accordingly, both the ILC<sup>35</sup> and the World Bank Guidelines from 1992 on "Legal framework for the treatment of foreign investment"<sup>36</sup> expressed caution regarding the discounted cash flow (DCF) method.

36. Despite these calls for caution and reservations, the DCF method remains the most widely used valuation method by ISDS tribunals. A study, which analysed 95 publicly available awards, has found that tribunals increasingly rely on income-based approaches, particularly the DCF method: between 2011 and 2015, they were used in 69% of the cases where compensation was assessed, compared to only 17% of the cases pre-2000, leading to increasing amounts of compensation<sup>37</sup>, that could vastly exceed the amount that the investor has invested.

**e. Valuation date**

37. 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 determined by the date of expropriation or the date before the impending expropriation became public, since public knowledge has an immediate influence on the value (see para. 14 above). In

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<sup>32</sup> See Beharry, p. 206.

<sup>33</sup> See also Beharry/Bräutigam, p. 17, 18.

<sup>34</sup> See PWC Study 2015, p.3

<sup>35</sup> ILC commentaries on Article 36, paras. 26-27.

<sup>36</sup> World Bank Group, Vol 2, para. 42.

<sup>37</sup> PWC Study 2015, p.3. See also Hart/Velez Study (2021), p. 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).



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cases of unlawful expropriation or other breaches of treaty obligations, there are generally two possible valuation dates: (i) the date of the breach; or (ii) the date of the award, which the tribunal needs to determine, depending of the circumstances of the case.

## 2. Causation

38. “Causation” is an essential element of liability; the harm needs to be attributable to the conduct of the State. Generally, appropriate standards or tests for proving causation are not included in treaties. Only a few treaties foresee language on causality, for example that investors may obtain compensation only for losses that occur “by reason of” or “arising out of state measure”.<sup>38</sup> More precise formulations require “(...) (d) 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.”<sup>39</sup>

39. Article 31 of the ILC Articles states that the injury needs to be caused by the internationally wrongful act. According to the commentary, the causal connection between the breach of the agreement and the loss claimed must not be too speculative, remote, or uncertain. It states that there are numerous terms used to describe the links which must exist between the wrongful act and the injury in order for the obligation of reparation to arise.<sup>40</sup> The terms are remoteness, directness, proximity and foreseeability. The ILC Articles do not express a preference for a specific legal test of causation<sup>41</sup> but notes that “the requirement of a causal link is not necessarily the same in every breach of an international obligation”.<sup>42</sup>

## 3. Evidentiary Requirements

40. As a generally accepted principle of international law, the party that relies on a fact bears the duty to prove it.<sup>43</sup> Accordingly, with regard to damages, the investor generally bears the burden of proof with regard to causality and the amount of loss claimed, whereas the respondent State bears the burden of proof with regard to defences, such as circumstances limiting the causality or the amount of a loss claimed.<sup>44</sup>

41. Most instruments in investment arbitration and decisions of arbitral tribunals are silent on the subject of standard of proof. Arbitration rules usually grant 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 tribunal “shall determine the admissibility, relevance, materiality and weight of the evidence offered.” Rule 34(1) of the ICSID Arbitration Rules also reflects a procedural freedom by stating that “the Tribunal shall be the judge of the admissibility of any evidence adduced and of its probative value”.

42. Article 36(2) of the ILC Articles clarifies that compensation shall cover damage that is financially assessable and established. For lost profits, the commentaries on 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 commentaries further indicate that the probability of anticipated future profits must be demonstrated with sufficient documentary or other appropriate evidence, which might be achieved by contractual arrangements or a well-established history of dealings.<sup>45</sup>

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<sup>38</sup> NAFTA (1993), Articles 1116 and 1117; 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.

<sup>39</sup> See India Model BIT (2003), Article 23 (2).

<sup>40</sup> ILC commentaries on Article 31, para 10.

<sup>41</sup> Marboe, *Damages*, pp. 39-86.

<sup>42</sup> ILC commentaries on Article 31, *supra* note 40, para 10.

<sup>43</sup> The burden of proof has been addressed in the UNCITRAL Arbitration Rules. They reflect the generally accepted principle that the party that relies on a fact must prove it. Article 27(1) of the UNCITRAL Arbitration Rules states that “each party shall have the burden of proving the facts relied on to support its claim or defence.” The 2010 IBA Rules on the Taking of Evidence in International Arbitration (IBA Rules) also reflect this principle by describing that the parties must submit all available documents to which they will rely on. The ICSID Arbitration Rules and the ICC Rules do not address the burden of proof directly, but tribunals generally follow the generally accepted principle as outlined in the UNCITRAL Arbitration Rules.

<sup>44</sup> Beharry/Bräutigam, p. 7.

<sup>45</sup> ILC commentaries on Article 36, para. 27.

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43. When addressing the standard of proof, common law systems usually apply the standard of the balance of probabilities, which requires that a claim is more likely to be true than not. By contrast, civil law systems apply the standard of the inner conviction of the adjudicator, which is sometimes argued to set higher standards than the common law standard of balance of probabilities.

44. In practice, tribunals have not adopted a unified approach but rather a variety of different standards of proof.<sup>46</sup>

#### **4. Interest**

45. It is recognized that interest forms an integral element of compensation. Given the length of arbitral proceedings, interest can constitute a significant amount of the overall compensation and is therefore, from an economic perspective, of eminent practical importance.<sup>47</sup>

46. Interest compensates the claimant for the loss of the use of its money; interest is considered to be necessary to fully compensate the claimant by restoring it to the position it would have enjoyed had the breach not occurred.

47. However, the general principle of full reparation does not define all the necessary elements for calculating interest, particularly the interest rate and the issue of compounding, which contribute to significant amounts of interests that might be awarded.

48. Some bilateral and multilateral investment treaties mention interest in the context of expropriation and indicate that interest should be granted “at a commercially reasonable rate” or a slight variation thereof,<sup>48</sup> accruing from the date of expropriation to the date of payment. A smaller number of treaties foresee interest as compensating for damages resulting from acts other than expropriation.<sup>49</sup> However, the treaties usually remain silent on the question of simple versus compound interest and on the issue of accruing intervals.

49. 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 interest runs “from the date when the principal sum should have been paid until the date the obligation to pay is fulfilled.”

##### **a. Rate**

50. Once the valuation date is decided, tribunals determine the pre-judgment interest rate. Tribunals often apply an interbank rate, such as the London Interbank Offered Rate (LIBOR) or the Euro Interbank Offered Rate (EURIBOR), based on a consideration that interbank rates would reflect more objective and predictable outcomes as compared to rates based on the creditworthiness of an individual investor. Tribunals also frequently apply an additional premium to the interbank rate (e.g., LIBOR + 2%, where 2% is the additional premium or uplift) to reflect a market value of money in a specific currency. Besides interbank rates, other options for an applicable interest rate 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.

##### **b. Post-award interest – potentially higher rates**

51. Post-award interest is primarily concerned with three factors: (i) preservation of the fair market value of the award; (ii) compensation for the risks of collection of the award,

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<sup>46</sup> Beharry/Bräutigam, p. 7.

<sup>47</sup> The PWC Study 2016 found that 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 p. 1.

<sup>48</sup> Such variations include “at a normal commercial rate” (Comprehensive Economic and Trade Agreement (CETA)) and “at a rate determined according to market criteria” (Brazil-India BIT 2020). In other cases, treaties substantively articulate beyond “a commercially reasonable rate,” adding that the interest “shall in no case be lower than the London Interbank Offered Rate (LIBOR)...” (Belarus-Hungary BIT 2019).

<sup>49</sup> See, e.g. Belarus-Hungary BIT 2019; Cabo Verde-Hungary BIT 2019.

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including a risk of default by the respondent; and (iii) desire to disincentivize the respondent from delaying payments and using the award as a source of cheap financing.

52. When tribunals have differentiated between the application of interest before and after the award, they have taken different approaches on the issue of 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 respondents 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.<sup>50</sup>

### **c. Simple or compound interest**

53. Another important factor is the determination of the mode of calculation, which involves the selection of simple or compound interest, as well as the selection of intervals at which interest is to accrue.

54. Tribunals have increasingly awarded compound interest. According to a study, the ratio of cases awarding simple versus compound interest was 50:50 before 2005, but in the years between 2011-2015, the ratio split has become to 13:87.<sup>51</sup> It is mainly the payment of compound interest that results in extremely large awards of interest, which can even exceed the principally awarded sum.<sup>52</sup>

55. In many national legal systems, compound interest is not allowed, and the commentaries 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.<sup>53</sup> The proponents of compound interest claim that the interest 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.<sup>54</sup>

56. Regarding the accruing intervals, it is noteworthy that tribunals often consider the period over which interest is to run and the intervals at which interest is to accrue separately. 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. Another way in which tribunals may differ in approach relates to the impact that the length of period will have on the interest calculated. For example, a tribunal reduced the compounding frequency because it felt that the resulting absolute amount of interest would be too high. In contrast, another tribunal felt that it should increase the compounding frequency because of the length of time during which the claimant had been without compensation.<sup>55</sup>

## **5. Role of Experts**

57. With respect to the quantification of compensation, both parties and tribunals regularly seek the assistance of experts. The choice and application of methodology, as well as the calculation of compensation, often require specialised and technical knowledge, in particularly where the valuation method requires in depth information on the industry.

58. A number of arbitration rules provide for the participation of expert(s) in arbitral proceedings and recognise party- and tribunal-appointed experts. The UNCITRAL

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<sup>50</sup> Beharry/Bräutigam, *Damages and Valuation in International Investment Arbitration*, p. 30

<sup>51</sup> PWC Study 2016, p.2.

<sup>52</sup> See for example the case: *Compania Del Desarrollo De Santa Elena, S.A. v. Costa Rica*: \$4.15 million in principal damages, and \$11.85 million in interest award, based on a rate that was compounded semi-annually (as opposed to \$5.7 million, if the tribunal had awarded simple interest), see paras. 85, 107 of the award, available at [http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C152/DC539\\_En.pdf](http://icsidfiles.worldbank.org/icsid/ICSIDBLOBS/OnlineAwards/C152/DC539_En.pdf)

<sup>53</sup> ILC commentaries to Article 38, paras. 8-12

<sup>54</sup> Beharry/Bräutigam pp. 29,30

<sup>55</sup> See J. Y. Gotanda, pp. 394

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Arbitration Rules explicitly provide for both expert witnesses “who are presented by the parties” (see Article 27(2)) and tribunal-appointed experts (see Article 29).<sup>56</sup> In addition, the ICSID Arbitration Rules generally foresee that each party presents its own witnesses and appoints its own experts but that the tribunal may also call upon the parties to produce further witnesses and experts if deemed necessary (see Article 43 of the ICSID Convention and Arbitration Rule 34).

59. 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 would make the proceedings more economical, as experts from the same discipline could identify in a relatively quick manner the reasons for their diverging conclusions and find areas of agreement.<sup>57</sup>

## **6. Factors limiting the amount of compensation**

60. States can have recourse to defenses such as the state of necessity in order to avoid the finding of a treaty breach, where the sole means of preserving an essential national/public interest threatened by a grave and imminent peril is by adopting measures inconsistent with their normal international obligations.<sup>58</sup> States can further refer to exceptions to the substantive standards. With regard to the amount of compensation, States can invoke two main defenses: (i) contributory fault and (ii) mitigation of losses.

### **a. Contributory fault**

61. Although treaties are generally silent on this issue, the amount of compensation may be reduced by the tribunal if the claimant’s own conduct contributed to the loss that it has 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 (see above under para. 18).

62. The notion of contributory fault is also 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”).

63. Various tribunals have recognised contributory fault in investment disputes.<sup>59</sup> Contributory fault cases can include violation of the State’s domestic law<sup>60</sup> and the increase of loss by the investor, for example as a result of the business risk.<sup>61</sup> Tribunals

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<sup>56</sup> The Model Law on International Commercial Arbitration gives a primary focus on tribunal appointed experts.

<sup>57</sup> Commentary on the revised text of the 2010 IBA Rules on the Taking of Evidence in International Arbitration, p. 20.

<sup>58</sup> Beharry/Bräutigam, p. 25; 1. Under the ILC Articles, the state of necessity precludes the wrongfulness of the States conduct, however compensation might be awarded nonetheless (see Article 27 ILC Articles). Further, several IIAs provide for the defense of necessity, which is meant to excuse a breach.

<sup>59</sup> 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 Ecuador); *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL, PCA Case No. 2005-04/AA227 (Yukos v Russia).

<sup>60</sup> See *Occidental v Ecuador*; *Yukos v Russia*; *Copper Mesa v. Ecuador Copper Mesa Mining Corporation v. Republic of Ecuador*, PCA Case No. 2012-2.

<sup>61</sup> The Impact of Contributory Investor Conduct: Only with Difficulty Commensurable', Mark A.

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generally have discretion to determine the extent to which the investor's contributory fault will affect the amount of compensation.<sup>62</sup>

**b. Failure to mitigate losses**

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

65. The principle of mitigation is widely recognized in different areas of law, including 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 Commissions Commission also recognised the claimant's duty to mitigate losses whenever possible. Accordingly, a claimant is not only permitted but obliged to take the necessary steps to mitigate the loss.<sup>63</sup>

66. The mitigation of damages has also been addressed in the commentaries on Article 31 of the ILC articles which clarify that it is not a legal obligation which gives rise to responsibility, but that a failure to mitigate may preclude recovery to that extent.<sup>64</sup>

67. The duty to mitigate and its limiting effect on recoverable damages have been accepted by tribunals in investment arbitration as a principle of international law. The burden of proof to establish the claimant's failure to mitigate the damages is on the respondent. 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 minimize the loss.

**D. Matters for consideration and possible work**

68. The Working Group may wish to consider the issues outlined below and, if the Working Group were to decide to undertake work on the matter, whether such issues could be addressed 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 procedure reform; and (ii) 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.

**1. The complexity and uncertainty of the current practice**

69. As shown in paras. 24-67, 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. This complexity contributes to a cost increase of ISDS proceedings and may negatively impact the correctness,<sup>65</sup> consistency<sup>66</sup> and predictability of awards related to the calculation of compensation.<sup>67</sup>

**Possible work**

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Kantor in Meg Kinnear, Geraldine R. Fischer, et al., *Building International Investment Law: The First 50 Years of ICSID*, 2015, p. 535 (Mark A. Kantor); *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7.

<sup>62</sup> *Occidental v Ecuador*; Mark A. Kantor, p. 540.

<sup>63</sup> Decision 15 of the UNCC Governing Council 'Compensation for Business Losses Resulting from Iraq's Unlawful Invasion and Occupation of Kuwait where the Trade Embargo and Related Measures Were also a Cause', 18 December 1992.

<sup>64</sup> ILC commentaries on Article 31, para. 11.

<sup>65</sup> See also the Academic Forum paper, section 4.2

<sup>66</sup> *Ibid*, section 4.1.

<sup>67</sup> See for example IISD, p. 30; BIICL study, pp. 26, 29.

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70. The Working Group may therefore wish to consider whether to undertake work on the development of treaty provisions, guidelines, or standards for tribunals to address the following issues:

- i. The compensation standard, in particular a clarification of the applicable standard for cases of non-expropriatory breaches;
- ii. The valuation method to be applied by the tribunal, in particular cases in which the application of the DCF method is appropriate;
- iii. The valuation date;
- iv. Potential limitations for compensation, in particular the consideration of the claimant's conduct before the breach;
- v. Causation standards;
- vi. Evidentiary requirements, including the standard of proof;
- vii. The issue of pre- and post-award interests by clarifying issues on defining the valuation date, the interest rate to be applied, and the mode of calculation, especially on whether compounding interest should be allowed;
- viii. The issue of selections of experts and their ethical regime;
- ix. Allocation of costs where various factors might be considered such as the outcome of the case, the parties conduct, the reasonableness<sup>68</sup>; and
- x. The primacy of restitution over compensation, as stated in the ILC Articles.

## **2. Valuation methods, including calculation of interest**

71. 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 (see above under paras. 5-11).<sup>69</sup>

72. 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.<sup>70</sup> From the first case in 1981, it took 21 years of cumulative awards of damages to grow to \$10 billion in 2002. In 2006, the cumulative amounts had doubled, reaching 20 billion USD and, 4 years later, the amount doubled again, reaching 40 billion USD in 2010.<sup>71</sup>

73. Moreover, commentators have noted that the amounts awarded often vastly exceed the investors' expenditures on the investment<sup>72</sup> (see para. 36), and that neither the benefit of the investment for the host State,<sup>73</sup> nor, the investor's misconduct, such as human rights breaches, is taken into consideration.<sup>74</sup>

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<sup>68</sup> Generally, there are two broad approaches: (i) the "costs follow the event" approach, where the unsuccessful party compensates the successful party, or (ii) the "pay your own way" approach, where each party bears its own legal costs and the arbitration costs are shared proportionally. However, tribunals often have discretion in the cost allocation, as it is generally not addressed neither in treaties nor arbitration rules.

<sup>69</sup> Ibid, p. 7, 19, 20, 39; IISD, pp. 28-29.

<sup>70</sup> See also IISD, p. 29

<sup>71</sup> 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/ITALAWdata, the median amount of awards between 1990-1999 amounted to 2 USD million, between 2000-2009 to 16.7 USD million and between 2010-2019 to 32.9 USD million, 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 USD million and between 2010-2019 to 27.8 million.

<sup>72</sup> IISD, p. 27.

<sup>73</sup> IISD p. 28

<sup>74</sup> IISD, p. 31; As an exception, the new Netherlands Model Investment Agreement (2019) provides

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- **Possible work**

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

- i. The use of valuation methods (see above, paras. 24 to 37) and calculation of interest (see above, paras. 45 to 56); and
- ii. The capping of compensation, for instance to the amount actually invested by the investor.<sup>75</sup>

75. In that context, the Working Group may also wish to include contextual factors for consideration by tribunals, 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.<sup>76</sup>

### **3. Discrepancy between compensation claimed and awarded**

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

77. A study has calculated that the average claims amounted to 910.6 million USD against an average award of 298.3 million USD.<sup>77</sup> Accordingly, investors claim on average three times the amount they are actually awarded. In a different scenario, 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.<sup>78</sup> On this basis, investors claim on average five times the amount they are actually awarded.

#### *Anchoring effect and cost allocation*

78. The so-called "anchoring effect" was discussed as a potential reason for the growth in large damage awards.<sup>79</sup> It is based on the observation that investors tend to make exaggerated claims as a legal tactic, thereby counting on a possible cognitive bias of tribunals that would lead to refer to the exaggerated claim as a reference for the calculation of compensation.<sup>80</sup>

79. The Working Group may wish to consider whether manifest over- or under-statements of the amount of damages could be addressed through guidance, for instance in guidelines on cost allocation,<sup>81</sup> and possibly also through the drafting of a provision on cost allocation. Such a draft provision could foresee that the claimant would bear a higher fraction of the

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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/>

<sup>75</sup> See for example suggested wording of such provision in IISD, p. 33.

<sup>76</sup> IISD, p. 31; See also Martins Paparinskis, A Case Against Crippling Compensation in International Law of State Responsibility, *The Modern Law Review*, Volume 83, Issue 6 (November 2020).

<sup>77</sup> 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.

<sup>78</sup> A study analysing 241 awards found that "damages awarded total almost \$71.91 billion on claims of over \$219 billion, which results in an average award as a percentage of claim amount of 32.8%". However, "[t]he average awarded amount was \$298.3 million on an average claim amount of \$910.6 million", Hart/Velez Study, p. 7.

<sup>79</sup> IISD, p. 28.

<sup>80</sup> IISD, p. 28.

<sup>81</sup> The increasing costs for counsel and experts might not be considered reasonable within the meaning of Rule 28(2) of the ICSID Arbitration Rules and therefore not be allocated.

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costs if the amount of damages claimed exceeds the proven amount by a certain percentage.<sup>82</sup>

#### **4. Divergence of expert damage calculations**

80. Closely connected to the divergence of compensation claimed and awarded is the wide divergence of compensation presented by claimants' and respondents' experts.<sup>83</sup>

81. A study found that such divergence on experts' results is partly due to the fact that experts are instructed by counsel and answer to different questions potentially based on different factual or legal assumptions, and treat factual issues differently as they genuinely have different opinions. Experts' lack of integrity or objectivity was not mentioned as an issue, but quality concerns were mentioned in a limited number of cases.<sup>84</sup>

##### *- Possible work*

82. The Working Group may wish to consider whether to undertake work on treaty provisions or guidelines<sup>85</sup> for tribunals which could set up a generalized system of expert(s) appointed by the tribunal to assist the decision-making process of the tribunal and replace the current practice of party appointed quantum experts.

83. This might strengthen the impartiality and independence of the expert evidence on quantum. Moreover, taking into consideration the costs of experts,<sup>86</sup> this approach might further alleviate the overall costs of the proceedings.<sup>87</sup>

84. Alternatively, treaty provisions or guidelines could be developed on the basis of the current system of party appointed experts which would:

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

## **E. Interrelation with other reform options**

85. The Working Group may wish to consider that certain questions related to damages and compensation also arise in the context of other reform options.

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<sup>82</sup> 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 percent or more, the tribunal shall allocate fifteen percent of the resulting difference as costs in favour of the respondent.

<sup>83</sup> PWC Study 2015, p. 2: A study found that the amount quantified by respondents' experts was, on average, 13% of the amount quantified by claimants' experts, which means there is an 87% difference in the quantification of damages; See also Beharry, p. 3-8.

<sup>84</sup> PWC Study 2015, p. 2 and 5.

<sup>85</sup> Such work could profit from guidelines and instruments that have already been drafted, such as the Protocol on Determination of Damages in Arbitration by CPR International Committee on Arbitration.

<sup>86</sup> See [A/CN.9/930/Rev. 1](#), para. 36: there is limited available information, but it is estimated that 80 to 90 percent of costs in ISDS are for fees for legal representation and for experts, and that the costs per proceeding averaged 8 million USD. See also OECD Working Paper, which found that case costs (including legal and expert fees) appear to average over 8 million USD, but it is unclear what percentage of the amount accounts for expert fees.

<sup>87</sup> ICSID recently noted that tribunal-appointed experts "are increasingly used," and it is consequently proposing a new rule reflecting this reality. See *Proposals for Amendment of the ICSID Rules — Working Paper, Volume 1, ICSID Secretariat, 2 August 2018, p. 6; ibid., Volume 3, p. 204.*



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86. Related aspects of speculative, unsubstantiated, and inflated claims may also be discussed with regard to possible mechanisms to address frivolous claims at an early stage of the proceedings and in an expedited process.<sup>88</sup>

87. The high amount of compensation claimed, as well as the increasing amount of compensation awarded may have been exacerbated by the increased use of third-party funding in ISDS.<sup>89</sup> The regulation of third-party funding, including options to restrict its use in ISDS, are being discussed by the Working Group as a separate reform solution.<sup>90</sup>

88. The inconsistency of ISDS decisions on the legal principles regarding damages and compensation is also being addressed with the reform options of appellate and multilateral court mechanisms.<sup>91</sup> These reform options aim at ensuring procedural and substantive correctness of decisions and at rectifying errors in decisions by ISDS tribunals.<sup>92</sup>

89. Moreover, the binding interpretation of provisions in investment treaties on the assessment of damages, as well as the calculation of the compensation, by the Parties to the treaty or by commissions formed under the treaties is being discussed in the context of reform options related to treaty parties' involvement in, and control mechanisms on, treaty interpretation.<sup>93</sup>

90. Damage-related questions also arise in the context of the reform options on multiple proceedings, shareholder claims and reflective loss in particular with regard to excessive compensation as a result of double-recovery.<sup>94</sup>

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<sup>88</sup> See A/CN.9/WG.III/WP.192, paras 21-30; A/CN.9/WG.III/WP.153, para. 86.

<sup>89</sup> See also A/CN.9/WG.III/WP.172 - Third-party funding.

<sup>90</sup> *Ibid.*

<sup>91</sup> See A/CN.9/WG.III/WP.185 - Appellate and multilateral court mechanism.

<sup>92</sup> *Ibid.*, para. 7; the link of concerns about incorrect calculation of damages by tribunals to other concerns, was also pointed out in the thirty-seventh session of the Working Group, see A/CN.9/970, para. 38.

<sup>93</sup> See A/CN.9/WG.III/WP.191, para. 28.

<sup>94</sup> See A/CN.9/WG.III/WP.170 - Shareholder claims and reflective loss, para. 22 and A/CN.9/WG.III/WP.193 - Possible reform of investor-State dispute settlement (ISDS) - Multiple proceedings and counterclaims.