

Book Reviews

Review Essay

Sornarajah, M., *The International Law on Foreign Investment*, Cambridge: Cambridge University Press (1994) xx + 428 pages + Index.

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Since the end of the Second World War, the world has witnessed an enormous and continuing increase in cross-border capital flows. International law, however, by not developing a body of law to deal with investment by multinational corporations (MNCs), has failed to keep pace with the changing needs of states. The result has been conflict between developed and developing states with respect to the state of customary law.¹ Faced with uncertain customary law, states have turned to bilateral treaties to encourage foreign investment. Despite efforts by certain authors to argue in favour of one rule or another,² it is widely accepted that customary law provides only very weak legal standards for foreign investment.³ In his recent book, *The International Law on Foreign Investment*, M. Sornarajah presents a thorough survey of the law of foreign investment. Sornarajah presents in a concise and readable form the basic issues in the law of foreign investment. While this book serves as a good introduction to the strictly legal questions relevant to foreign investment, the discussion lacks an analytical discussion of the laws it presents.

The contents of the book can be divided into three substantive sections. The first, which includes chapters 3 and 4, deals with the rights and responsibilities of the host state and the home state of the MNC respectively; chapters 5 and 6 discuss multilateral and bilateral treaties developed in an attempt to deal with the problems facing foreign investment; and chapters 7-9 tackle the taking of property and compensation.

One of the few international legal norms of foreign investment about which there is widespread agreement is the right of a state to exercise complete control over the entry of foreign investment (p. 83). This unremarkable statement must be the starting point of a discussion of the law of foreign investment because it ensures a minimum level of territorial

- 1 'In the second half of the twentieth century, apart from the international law on the use of armed force, no area of international law has generated as much controversy as the law relating to foreign investment' (p.1).
 - 2 See, e.g., Amerasinghe, 'Issues of Compensation for the Taking of Alien property in the Light of Recent Cases and Practice', 41 *ICLQ* (1992) 22, 62 (arguing that 'the standard of full compensation has been uniformly implemented in all instances of lawful expropriation or nationalization, with the exception of the *Libyan American Oil Co. Arbitration...*'); Lee O'Connor, Note, 'The International Law of Expropriation of Foreign-Owned Property', 6 *Loy. L.A. Int'l & Comp. L.J.* (1983) 355, 356 (arguing that 'international law grants the primary responsibility of setting the amount of compensation to the taking state. Only when the amount of indemnification paid does not comport with some subjective, ad hoc standard of reasonableness will international law refuse to defer to the sovereignty of the expropriating nation').
 - 3 See, e.g., Dolzer, 'New Foundations of the Law of Expropriation of Alien Property', 75 *AJIL* (1981) 553, 553 ('[T]he present state of customary international law regarding expropriation of alien property has remained obscure in its basic aspects.');
- Hanson, Aranda, 'An Emerging International Framework for Transnational Corporations', 14 *Fordham L. Rev.* (1991) 881, 883 (stating that there is uncertainty 'about the specific content of international customary law rules regarding the protection of private property abroad').

sovereignty – regardless of the protections provided for foreign capital the host can always choose to simply exclude the investment.

There is also widespread agreement that a state must provide at least national treatment to foreign investment. There is debate, however, over whether there also exists an external, international standard of treatment to which foreign investors are entitled, regardless of the treatment provided to nationals (p. 83 n.1). There are at least two competing points of view: the Hull rule⁴ ('prompt, adequate and effective' compensation), often advocated by capital exporting countries (p. 220) and partial compensation,⁵ preferred by capital importing states (p. 258-259). Following a detailed discussion of the rights of the host state, (pp. 83-142), Sornarajah concludes that '[t]he principle of sovereignty over economic activity that takes place within the state has not been eroded despite the efforts on the part of developed states to create an external standard with which the exercise of such sovereignty must conform' (p. 142). Sornarajah overstates his claim on this point as there remains great controversy regarding the correct standard of compensation.⁶ Regardless of what the correct standard is, however, it is clear that an investor who relies on the protection of international law against actions taken by the host state accepts a large risk as that protection is uncertain and unreliable.

While it will generally be true that commitments made by the MNC can be enforced by the host state's domestic legal system,⁷ there is serious doubt about the ability of the state to make binding commitments to the MNC (p. 86-87).⁸ Because MNCs lack international personality, they cannot enter into binding agreements with states.⁹ Commitments made by the state are obviously of limited value in an international legal regime under which those commitments are non-binding. The MNC is left with only the protection of customary international law. This is, of course, a problem for a potential host state that may want to offer an investor certain guarantees in order to secure the investment.

Having established the weakness of customary law, Sornarajah moves on to treaties. There are currently no multilateral treaties governing foreign investment (p. 187). Bilateral investment treaties (BITs), on the other hand, exist in large number and are of tremendous importance¹⁰ (p. 225). BITs are of great interest because they represent a solution through public international law of what is, essentially, a private international law issue – offering a solution to the problem of contracting between investors and the host state discussed above. By establishing a treaty with the home state of the MNC, the problem of international personality is overcome and the relationship becomes subject to international law.

Sornarajah ably presents the current state of the law and appropriately emphasizes the importance of BITs. Unfortunately, he does not enter into a discussion of the impact of BITs

4 See, e.g., Gann, 'Compensation Standard for Expropriation', 23 *Colum.J. Trans.L.* (1985) 615, 616; Mendelson, 'Compensation for Expropriation: The Case Law', 79 *AJIL* (1985) 414.

5 This standard is sometimes termed 'appropriate' compensation. For a general discussion of the different standards that are advocated, see Amerasinghe, *supra* note 2, at 23-25.

6 See, e.g., Hansen, Aranda, *supra* note 3, at 883.

7 See, e.g., 'Proposed Text of the Draft Code on Transnational Corporations', Art. 50, UNCTC, E/1988/39/Add. 1 (1988) ('States have the right to regulate entry and establishment of transnational corporations including determining the role that such corporations may play...').

8 Even an agreement that explicitly allows for expropriation may not change the legal status of investment. See, e.g., Clagett, 'Protection of Foreign Investment Under the Revised Restatement', 25 *Va.J. Int'l L.* (1984) 73, 95 (citing Restatement (Second) of Foreign Relations Law of the United States (Revised), §185, comment f (Tent. Draft No. 3, 1982)).

9 Here, 'binding' refers only to international law. The agreements will, in general be binding within the host state, but this is much more likely to be used against the MNC rather than work in its favor. Should the host decide to 'breach' the agreement, it can simply alter the laws in place and thereby change the terms of the agreement.

10 See World Bank Group, *Legal Framework for the Treatment of Foreign Investment*, Vol. 1, (1992) 17-23 (listing BITs).

on foreign investment and on LDCs. In fact, economic analysis (which considerations of space prevent us from elaborating) will show It is important to consider whether BITs yield an efficient allocation of capital and if LDCs are served by these treaties.

Consider a foreign investment project under which the MNC would invest capital and, in exchange, the host would guarantee a certain tax treatment, allow repatriation of profits, and so on. We assume that this project is beneficial to both the MNC and the host.¹¹ Economic analysis (which considerations of space prevent us from illustrating) will show that giving the LDCs the ability to commit (through BITs or some other mechanism) creates an efficient framework for foreign investment.

We can enrich our example by assuming that the host is concerned not only about the current investor, but also future investors. By honouring its commitment to one firm, the host may be able to establish a reputation for honouring its agreements and thereby attract more investment.

In the above situation the host faces a market constraint rather than a contractual commitment. If it expropriates, it will suffer the loss of some investment. Is this solution as good as a regime that allows for contracting? It is unlikely to be as effective because a contract can specify the appropriate level of damages, whereas future investment will, in general, be unrelated to the actual damages inflicted by the 'breach.' A contractual damages clause can set the level of damages that is consistent with the efficient outcome,¹² but the cost to the host of breaching an agreement under a regime without contracting may be lower or higher than the optimal level. For example, during a period of investment, in which large sums of capital are flowing into the country, a country may be extremely hesitant to violate an agreement that it had previously made, even if the costs imposed by the MNC (through pollution, use of resources, etc.) exceed the damages that would be needed to compensate the MNC for a change to the agreement.¹³

A contractual solution (including through a BIT) is, therefore, a more efficient rule for the regulation of foreign investment. Similarly, the Hull standard of full compensation would yield the efficient outcome because full compensation is the efficient level of 'damages'. A reputational mechanism allows the host to overcome the commitment problem to some extent, but will not, in general, yield the efficient outcome.

Having established that efficiency can be obtained through BITs, the Hull rule, or contracting, but not under a regime of partial compensation, we now consider the distributional effects of the various possible rules.

In particular, we examine a very simple case, in which LDCs are competing to attract foreign investment. In that case, we would expect LDCs to bid against one another – offering the MNC greater and greater concessions until the benefits to the LDC are fully captured by the MNC in the form of concessions by the 'winning' host state.¹⁴

- 11 Projects which will not benefit both the MNC and the host will not take place because either the MNC will decide not to invest or the host will use its power to prevent entry to keep the investment out.
- 12 The parties will seek to establish a level of damages that is consistent with efficient breach.
- 13 This is one possible explanation of why expropriations are so rare in recent years. If the flow of investment is large enough with respect to existing foreign capital, the cost of expropriation will exceed the benefits. In this situation, even efficient expropriations will not take place because the cost exacted by the market will be too great.
- 14 The alternative of a single host state choosing from among several potential investors is less realistic because states can accommodate several investors while each MNC will only invest in one country at a time and will, in general, be able to invest in any one of several countries.

The above example suggests that if potential hosts are able to simply pay the MNC to invest in the country, the standard of compensation for expropriation may be moot.¹⁵ A rule specifying lower payment in the event of expropriation¹⁶ will simply lead to a greater payment by hosts in order to attract investment. If, however, there are constraints on the ability of LDCs to make concessions to MNCs, the choice of compensation rule may be significant. For example, it may be politically unacceptable for a government to simply pay the MNC when it invests – limiting the concessions that the host government can make to issues such as taxation and the repatriation of profits. In this case, LDCs may be unable to bid more for the investment than they are already doing and will benefit from the lower expropriation standard. In other words, changing the expropriation standard will benefit the LDC by delivering to it a larger share of the benefits from the investment.

The lower standard with respect to expropriation will, of course, be a cost to MNCs and may cause some of them not to invest. If LDCs, as a group, are truly operating at the limit of their ability to make concessions to MNCs, the firm must either accept a smaller share of the benefits from its investment or, if the risk of expropriation makes investment in an LDC unprofitable, it can simply refrain from investing.

We now consider the impact of BITs on the welfare of LDCs. These treaties serve to bring agreements between investors and hosts under international law by imposing the home state of the multinational between the parties.¹⁷ By establishing a treaty between two states that requires each state to provide certain protections and rights to investors from the other state, the BIT provides protection under international law that is not provided by customary law.¹⁸

While BITs serve an important purpose by allowing LDCs to bind themselves in such a way as to protect investment, it is not certain that these treaties offer the developing country any advantages over a regime that allows binding contracts between investors and LDCs, or even over the Hull formula. The basic position of the LDC is not changed by the BIT – it must establish sufficient incentives and protections to attract capital from MNCs. Furthermore, it is reasonable to assume that the developed country with whom the LDC must negotiate a BIT will pursue the interests of its MNCs, leading to an arrangement similar to what would be agreed between the LDC and an MNC; and perhaps leading to the Hull formula.¹⁹ If this is true, and if the compensation standard matters at all, LDCs may be better off as a group with the existing customary law, without BITs.

LDCs may prefer BITs over a customary rule of international law that protects investment because a BIT is a formally voluntary arrangement, while customary law applies to all LDCs. If an LDC is able to attract foreign investment (either in general or within a

15 This conclusion depends on the assumption that LDCs compete aggressively for investment and that investors can choose between at least two LDCs between which, all else equal, they are indifferent.

16 For example, the standard of 'appropriate' compensation as specified by UN G.A. Res. 1803 (XVII), 17 UN GAOR, Supp. (No. 17) 15, UN Doc. A/5217 (1962), reprinted in 2 ILM (1963) 223 and reiterated in the Charter of Economic Rights and Duties of States, UN G.A. Res. 3281 (XXIX), 29 UN GAOR, Supp. (No. 31) 50, UN Doc. A/9631 (1974), reprinted in 14 ILM (1975) at 251, 254 is accepted to be a lower standard than the 'Hull Rule' requiring 'prompt adequate and effective' compensation.

17 For a discussion of BITs and their recent importance, see United Nations Center on Transnational Corporations, 'Bilateral Investment Treaties' (1988), Salacuse, 'BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries', 24 *Int'l Law* (1990) 655.

18 The substantive provisions of a BIT generally cover the required standard of treatment of investment, repatriation of profits, nationalization and compensation terms, clauses requiring the protection of commitments made between the MNC and the host, and dispute resolution clauses (pp. 237-275).

19 Because the Hull formula is the efficient outcome, we would expect that it would appear in BITs with some regularity, as is the case (pp. 255-260).

particular industry) without a BIT, that country is free to remain without one, thereby requiring firms to rely exclusively on the weak protections provided by customary international law.

Whether a given country is better with a BIT or without one is, of course, an empirical matter. Again, considerations of space prevent full analysis to illustrate the cost-benefit permutations for an LDC of choosing a BIT and which also explain the reasons why certain countries and regions have embraced BITs while others have chosen not to sign any at all.²⁰ If, however, LDC are effectively forced to accept BITs (either due to pressure from developed countries or by the market for foreign investment), the advantage of BITs over the Hull rule is called into question.

If a network of BITs were established to cover all foreign investment, we would essentially have a world in which contracts between host states and MNCs have international effect. Indeed the LDC would then face two levels of conditions – those contained in the BIT itself and those contained in the investment agreement and protected by the BIT. In other words, if all or nearly all LDC were to succumb to pressure either from developed states or from the market for investment to sign BITs, the benefits of the BIT for LDCs would be lost and developing states would face binding international rules protecting investment – rules that would almost certainly have been drawn up by developed states. Casual observation suggests that this situation may be developing, as countries that ‘maintain stances that oppose the Hull formula in international fora ... are busy making bilateral treaties containing the formula’ (p. 259). Despite his strong opposition to the Hull formula²¹ Sornarajah does not seem troubled by its adoption through BITs, stating that developing states are ‘prepared to accord a higher standard of protection ... in the hope of attracting investments’ (p. 259). Indeed, he ultimately supports BITs as a useful tool for developing states (‘the best solution ... is for states to settle the issue of compensation through bilateral investment treaties and agree upon a standard of compensation between themselves’ (p. 414)). Before advocating BITs, Sornarajah and other who are opposed to the Hull formula should ask if BITs are anything more than a mechanism for achieving an equivalent international law standard through different means. If the demise of the Hull rule as an international law standard was good for developing states, as is often assumed, the rise of BITs may be harmful to them, and may even mean a return to that standard.

The International Law of Foreign Investment provides a sound presentation of the current state of the law of foreign investment. It is, therefore, a fine introduction the area. Unfortunately, it offers few strong conclusions and limited analysis of the issues. As demonstrated in this review, the inability of states to contract generates a loss of efficiency at a global level – the cost of investment increases for firms, thereby reducing the amount of investment. The rise of the BIT may represent an attempt on the part of states and the market to arrive at the efficient solution. On the other hand, the distribution of the rents from foreign investment may favour the LDC more under a regime without contracting than under a regime with contracting. BITs may leave LDCs in the same position with respect to investment as they were under the Hull rule. Whether this represents a loss to LDCs depends, at least in part, on the elasticity of demand for the LDCs resources.

- 20 I do not claim that this is the only possible explanation for the decisions LDCs make with respect to BITs, merely that it is a potential factor. For example, the long-standing Calvo doctrine, which advocates national treatment for foreign investors, is surely partly responsible for the fact that very few BITs have been signed by Latin American countries. See Salacuse, *supra* note 17, at 661.
- 21 ‘[T]here is no evidence that can be found limiting the right of a state to nationalize except on the payment of full compensation’ (p. 402).