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Aligning Legal Responsibility with Wrongfulness in the Calculation of Compensation in Investment-Treaty Disputes

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Readers with antennas tuned to the happenings of the reform process for investor-State dispute settlement at UNCITRAL will know that the topics of damages and causation are on the agenda. Indeed, at the last sessional meeting of Working Group III, draft provisions on damages and causation were discussed. These provisions might find their way into the treaty that (possibly) emerges from the reform process. One vision is to create a large multilateral treaty that would alter the existing investment treaties among its parties. Accordingly, this is a once-in-a-generation moment to change the rules on damages and causation, and to have such change apply to many future investor-State disputes. With that background, this blog post proposes new rules on damages and causation, which can be found in the concluding paragraph.

A Puzzling Practice in the Calculation of Compensation

These rules are aimed at eliminating a puzzling practice that is sometimes seen in the calculation of compensation in investment-treaty arbitration. This practice is well illustrated in the case of *Eiser v Spain*. As a brief factual background, the investor was receiving subsidies for electricity that it was producing (from clean energy) for the Spanish grid. Spain subsequently reduced these subsidy payments. With that reduction, Spain was found to have breached (para. 418) the Energy Charter Treaty, specifically the rule on fair and equitable treatment. It was ordered to pay EUR 128 million (plus interest) to the investor, although the arbitral award was subsequently annulled (see link). In the opening to its legal reasoning on whether Spain breached the rule on fair and equitable treatment, particularly its strand on legitimate expectations, the arbitral tribunal clarified (para. 363) that:

The ECT did not bar Spain from making appropriate changes to the regulatory regime . . .. Thus, the Tribunal does not accept Claimants' contention that [the regulatory regime] gave them immutable economic rights that could not be altered . . .. Nevertheless, the ECT did protect Claimants against the total and unreasonable change that they experienced here.

This last sentence is thought-provoking. It indicates that Spain could have made 'reasonable changes' to the regulatory regime, and not have been in breach of the Energy Charter Treaty if it had done so. For illustrative purposes, imagine that the investor received a 100-ducat subsidy per month, and a fair-and-equitable reduction would have been to 85 ducats. In this (hypothetical) case, Spain would not have breached the Energy Charter Treaty, meaning that the investor would not have been awarded compensation, notwithstanding that it would have sustained some loss. In the actual case, the investor did (originally) receive compensation, and, again, suppose for illustrative purposes that Spain reduced the subsidy-payment to 60 ducats per month. Here is the interesting thing about this actual case: the investor recovered compensation for all of its losses.

As a select number of arbitral tribunals have implicitly recognised (*see Kruck v Spain* (para. 354), *RENERGY v Spain* (para. 1030), *AES v Spain* (para. 648), and *RREEF v Spain* (para. 534)), this outcome is somewhat puzzling. In the hypothetical world where the subsidy-payment is reduced to 85 ducats per month, the investor is not compensated, but the moment Spain's reduction goes 'too far,' the investor is compensated for all of its losses. It is proposed that investors should only receive compensation caused by the wrongful aspect of the State's conduct. This idea requires some unpacking. The 'wrongful aspect' of the State's conduct is that aspect of its conduct that, in respect of the rule on fair and equitable treatment, makes it unfair and inequitable. In *Eiser v Spain*, remembering that (illustratively speaking) a reduction to 85 ducats per month was acceptable, but the actual reduction to 60 ducats was unacceptable, then this means that the wrongful aspect of Spain's conduct was this additional 25-ducat reduction. The objective is to award the investor compensation in an amount that reflects the loss caused by this 'wrongful aspect.' The equation for this purpose is straight forward: actual losses minus hypothetical losses. To be clear, the hypothetical losses are those losses that would have occurred if the State had performed the same kind of conduct that it actually performed, but in a way that did not breach the rule on fair and equitable treatment; in other words, and with reference to the example of *Eiser v Spain*, the loss that would have befallen the investor if Spain had only reduced the tariff to 85 ducats.

A New Method of Calculating Compensation

Calculating compensation according to this formula would bring change to the usual method of calculating. The general rule is that reparation must wipe out all the consequences of the illegal act. This new method of calculating compensation follows this rule, with a slight tweak to ensure that only consequences arising from what makes the State's conduct illegal are compensable. This method has the advantage that it better aligns legal responsibility (the payment of compensation) with the wrongfulness of the State's conduct. In this way, this proposal ultimately draws its force from the principle that legal responsibility should be proportionate to wrongfulness. This proposed change is not only theoretically pleasing, but it also has an important practical benefit: it could help to thaw out regulatory chill. When States know that their compensation-payouts are limited to the extent that they go 'too far,' this factor can only encourage them to more frequently exercise their regulatory freedom.

Is awarding compensation only for wrongfully caused losses practically possible? The calculation proceeds in three steps.

The first examines whether the investment-treaty obligation that the State has breached contains an objective fault element. Because of the limitations inherent in any blog post, a full account of 'objective fault elements' cannot be given here. In summary, they refer to elements within rules that measure the quality of their subjects' conduct against an objective standard. In international investment law, the paradigm example is the ‘fair and equitable’ element in the rule on fair and equitable treatment, which provides that only unfair and inequitable conduct can breach this rule. Examples of other investment-treaty obligations with objective fault elements are the rules on free transfer of capital and full protection and security.

The second step asks: has the wrongful aspect of the State’s conduct caused the investor’s loss? Answering this question involves determining the non-wrongful version of the State’s conduct and asking whether that conduct would have caused the investor’s loss. If the answer is ‘no,’ then there is causality. This test of causation was used in *Bilcon v Canada*. The arbitral tribunal asked (paras. 168-72) if Canada had correctly processed the investor’s application for a permit (the non-wrongful version of its conduct), would the investor have suffered the loss that it did? The answer was ‘yes,’ meaning that the investor could not prove causation. If there is causation, then the arbitral tribunal proceeds to the third step, which is to calculate the compensation according to the equation ‘actual loss minus hypothetical loss.’

Turning Legal Theory into Legal Reality

In concluding, the final question is: how might this theory become legal reality? The journey towards legal reality begins with putting forth some draft provisions that could be included in the treaty that emerges from the reform process. These provisions are not in their final form, but they are a foundation to work from if States wish to rework the rules on damages and causation in order to align legal responsibility with wrongfulness:

Section Y – Testing for Causation in respect of Breaches of Investment-Treaty Obligations with Objective Fault Elements

1. *This section applies to cases where the investor alleges that the State has breached an investment-treaty obligation that contains an objective fault element.*
2. *In cases falling under section Y(1), causation between the State’s breach and the investor’s loss is established if the wrongful aspect of the State’s conduct factually caused this loss.*
3. *In this section:*
    1. *‘Objective fault element’ means an element within an investment-treaty obligation that measures the quality of the State’s conduct against an objective standard; and*
    2. *‘Wrongful aspect of the State’s conduct’ means that aspect of the State’s conduct that satisfies the objective fault element.*

Section Z – Calculating Compensation for Breaches of Investment-Treaty Obligations with Objective Fault Elements

1. *This section applies if the arbitral tribunal awards compensation to the investor to remedy the State’s breach of an investment-treaty obligation containing an objective fault element.*
2. *In cases falling under section Z(1), the State must pay compensation to cover the extent of the investor’s loss caused by the wrongful aspect of its conduct. This figure equals the investor’s actual loss minus the investor’s hypothetical loss.*
3. *In this section:*
    1. *‘Investor’s actual loss’ means the loss caused by the State’s conduct, which is in breach of the relevant investment-treaty obligation; and*
    2. *‘Investor’s hypothetical loss’ means the loss that the State would have caused if it had*

performed the non-wrongful version of its conduct.

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