

2007 GROTIUS LECTURE

**REGULATING MULTINATIONAL
CORPORATIONS: TOWARDS PRINCIPLES OF
CROSS-BORDER LEGAL FRAMEWORKS IN A
GLOBALIZED WORLD BALANCING RIGHTS
WITH RESPONSIBILITIES**

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I. THE IMPORTANCE OF CORPORATIONS AND THE PROBLEMS THEY PRESENT

An increasing fraction of commerce within each country is conducted by corporations that are owned and controlled from outside its borders and that often conduct business in dozens of countries. These corporations have brought enormous benefits. Indeed, many of the benefits attributed to globalization, such as the closing of the knowledge gap between developing and developed countries—which is even more important than the gap in resources—is due in no small measure to multinational corporations (“MNCs”).¹ More important than the capital that MNCs bring² are the transfer of technology, the training of human resources, and the access to international markets.

In recent years, especially following the collapse of the initiative to create a Multilateral Agreement on Investment (“MAI”) within the Organization for Economic Cooperation and Development (“OECD”),³ there has been a proliferation of bilateral investment treaties (“BITs”)⁴ and investment provisions within bilateral free

1. This lecture draws heavily from Chapter 7 of *Making Globalization Work*. JOSEPH E. STIGLITZ, *MAKING GLOBALIZATION WORK* (2006).

2. Indeed, in a country like China, sitting on \$1.3 trillion of reserves, there is little value to the capital itself. See Becky Yerak, *Firm Looks to Tap Chinese Capital: U.S.-China Owned Company Focuses on Mergers, Acquisitions*, CHI. TRIB., Oct. 2, 2007, at 2.

3. The initiative to create a MAI collapsed in October 1998 when the French Prime Minister Lionel Jospin announced his government would no longer participate in the talks. Guy de Jonquieres, *Retreat over OECD Pact on Investment*, FIN. TIMES, Oct. 21, 1998, at 4. Developing countries worried that new obligations would be imposed on them and that the agreement would bring little benefit. There is an interesting parallel with the failure of the multilateral trade talks: each was followed by a proliferation of bilateral agreements that were in general even more disadvantageous to the developing countries.

4. The number of such agreements has been increasing so rapidly that it is hard to keep track. According to the U.N. Conference on Trade and Development (“UNCTAD”), which tries to monitor them, the numbers almost doubled between 1995 and 2005, increasing from 1,322 to 2,495. In 2005, seventy BITs were successfully negotiated. This was the fewest number of BITs concluded in any year since 1995. These figures only include BITs, which make up slightly less than half of all International Investment Agreements. U.N. Conference on Trade and Dev. [UNCTAD], *Developments in International Investment Agreements in 2005*, at 2-7, U.N. Doc. UNCTAD/WEB/ITE/IIA/2006/7 (2006), available at http://www.unctad.org/en/docs/webiteiia20067_en.pdf.

trade agreements (“FTA”).⁵ Some countries, such as Indonesia, have even passed laws providing similar investment guarantees.⁶

These agreements are purportedly designed to provide greater protection for investors, thereby encouraging cross-border investment. There is, to date, little evidence that they have done so.⁷ Part of the reason is that they may, in fact, curtail development strategies in ways which are adverse to growth. As the U.N. Economic Commission on Latin America and the Caribbean concluded, “Countries of-

5. These so-called FTAs are not really FTAs but managed trade agreements. An FTA would eliminate not only tariffs, but also non-tariff barriers and subsidies. None of the FTAs do that. See JOSEPH E. STIGLITZ & ANDREW CHARLTON, *FAIR TRADE FOR ALL: HOW TRADE CAN PROMOTE DEVELOPMENT* (2005) and STIGLITZ, *supra* note 1, for a detailed discussion of how to craft trade policies that benefit both developed and developing countries.

6. See, e.g., *Indonesia: Forex Regulations*, EIU VIEWSWIRE (Indon.), Feb. 21, 2006, at 26 (“Indonesia does not restrict the transfers of funds to or from foreign countries, but incoming investment capital requires approval.”).

7. See Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract FDI? Only a Bit . . . and They Could Bite* 22-23 (World Bank Dev. Research Group, Working Paper No. 3121, 2003) (arguing that because BITs complement rather than substitute domestic institutions, their benefits are limited to countries with underdeveloped domestic institutions). In a 1998 study, UNCTAD found similar results. See U.N. CONFERENCE ON TRADE & DEV., *BILATERAL INVESTMENT TREATIES IN THE MID-1990S*, at 122, U.N. Doc. UNCTAD/ITE/IIT/7, U.N. Sales No. E.98.II.D.8 (1998) (concluding a weak positive correlation between BITs and FDI). But see Eric Neumayer & Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*, 33 *WORLD DEV.* 1567, 1582 (2005) (finding a robust correlation between the conclusion of BITs and the inflow of FDI); Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work? An Evaluation of Bilateral Treaties and Their Grand Bargain*, 46 *HARV. INT'L L.J.* 67, 111 (2005). While some studies have come to the opposite conclusion, the weight of the evidence suggests that BITs have had little, if any, positive effect on FDI. Still other scholars have found that any positive result disappears when the sample is altered or when BIT characteristics are controlled for or both. See Jennifer Tobin & Susan Rose-Ackerman, *Foreign Direct Investment and the Business Environment in Developing Countries: The Impact of Bilateral Investment Treaties* 31 (Yale Law Sch., Ctr. for Law, Econ. & Pub. Pol’y, Research Paper No. 293, 2005), available at <http://ssrn.com/abstract=557121> (concluding that there is no positive effect between BITs and FDI). What is clear from this literature is that there is no compelling evidence that these bilateral investment agreements have an economically or statistically significant effect on growth, let alone societal well-being. This paper will provide part of the explanation for why that may be so.

ten find that they have assumed obligations which, further down the road, will place limitations on their own development programmes.”⁸

This paper is concerned with a set of more fundamental issues. Even if it could be established that BITs lead to increased investment, and even if that investment could be shown to lead to higher growth, as measured by increased gross domestic product (“GDP”),⁹ it does not mean that societal welfare will increase, especially once resource depletion and environmental degradation are taken into account. BITs are designed to impose restraints on what governments can do—or, at least, impose a high cost when they undertake certain actions. Some of the activities that may be constrained may be im-

8. U.N. ECON. COMM’N FOR LATIN AMERICA & THE CARIBBEAN, FOREIGN INVESTMENT IN LATIN AMERICA AND THE CARIBBEAN 2000, at 15, U.N. Doc. LC/G.2125-P/I, U.N. Sales No. E.01.II.G.12 (2001).

9. An increase in foreign investment may not lead to higher growth if, for instance, foreign investment displaces domestic investment. It is important, of course, to measure growth appropriately, taking into account the depletion of natural resources and the degradation of the environment. Moreover, countries should not concentrate on GDP (the focus of most empirical studies), but instead should concentrate on Net National Product. The former looks at output produced within a country, the latter at the (net) income of the citizens of the country. Roland Spant, *Why Net Domestic Product Should Replace Gross Domestic Product as a Measure of Economic Growth*, 7 INT’L PRODUCTIVITY MONITOR 39, 39-40 (2003). If output increases, but all of the resulting increased income goes to foreigners, it obviously is of little benefit to the citizens of the country. Using these concepts, it is even easier to see how foreign investment could increase while the well-being of citizens decreases. For instance, some of the mines in Papua New Guinea caused significant environmental degradation; the low royalties the country received may not have been enough to offset this damage. See Geoff Spencer, *Development vs. Environment in South Pacific Papua New Guinea: Prime Minister Acknowledges Threat to Ecology, But Opposes Lawsuits Filed by Villagers Against a Polluting Mine. He Wants Nothing to Scare Away Foreign Investors.*, L.A. TIMES, July 10, 1994, at A6 (acknowledging the economic benefits of a mine while emphasizing the impact of the resulting pollution on hundreds of local clans).

There is another dimension to societal well-being about which this paper will have little to say: foreign investment can lead to an increase in inequality. This inequality likely will not be reflected in a country’s GDP because standard measures of GDP per capita look only at averages. Median income could decrease as average income increases, causing a majority of citizens to be worse off. For example, mines that pollute rivers will decrease the income of poor fishermen, while creating a few high paying jobs. See Michael Booth & Alyssa Bleck, *Mining in Papua (New Guinea)*, Case Number 177, Trade and Environment Database (1996), <http://www.american.edu/ted/papua.htm> (discussing the government’s efforts to increase the mining revenues, despite the severe environmental damage caused by the mines, including depletion of local fishing reserves).

portant for promoting general societal well-being—even if the profits of particular firms are affected adversely. It is this possibility that makes BITs the subject of such concern and debate.

All BITs are not identical; their effects are in themselves the subject of some controversy. As in any agreement, the interpretations of particular words and the judicial processes through which these words are given meaning can be a source of dissatisfaction. Different arbitration panels have interpreted the same words differently, creating a high level of uncertainty, among both governments and investors, about exactly what BITs can accomplish.¹⁰ This paper is focused not on any specific BIT, but on the general thrust of these BITs, which goes substantially beyond protection against expropriation.

Many of the BITs—including some of their most controversial aspects—are concerned with the far broader issue of what happens when changes in regulations or other government policies adversely affect the value of a foreign-owned asset.¹¹ BITs do not, of course,

10. The most notorious examples are arbitral decisions involving Argentina and Czech Republic. *See* LG&E Energy Corp. v. Argentine Republic, Decision on Liability, ICSID Case No. ARB/02/1 (Oct. 3, 2006), 46 I.L.M. 40; CMS Gas Transmission Co. v. Argentine Republic, Award, ICSID Case No. ARB/01/8 (May 12, 2005), 44 I.L.M. 1205 [hereinafter *CMS Gas Transmission Co.*, Award]; CME Czech Rep. B.V. v. Czech Rep., Partial Award, (UNCITRAL, Sept. 13, 2001) [hereinafter *CME Czech Rep. B.V.*, Partial Award]; *Lauder v. Czech Rep.*, Final Award, (NAFTA/UNCITRAL Sept. 3, 2001). Other examples are provided by decisions concerning standards of compensation. While most arbitral panels have ruled against compensation for lost profits, in *Karaha Bodas Co. LLC v. Perusahaan Pertambangan Minyak Dan gas Bumi Negara*, a Swiss Panel awarded \$319 million to Karaha Bodas (including \$58 million in interest), while the company's incurred costs totaled only \$111 million. *See* John Aglionby & Taufan Hidayat, *Pertamina Settles Power Dispute*, FIN. TIMES, Mar. 22, 2007, at 16; Moch. N. Kurniawan, *Pertamina Should Pay Compensation to Karaha: Experts*, JAKARTA POST, Mar. 20, 2002, at 11. The lost profits may have been particularly large in this case because of possible corruption in the award of the contract under Suharto—one of several aspects of the case that might be particularly galling to Indonesians. So too was the view that they had been encouraged by outside advisers to cancel the disadvantageous, and possibly corrupt, contract. *See* Official Website of Karaha Bodas Co. L.L.C., <http://www.karaha-bodas.com> (follow "Legal Dispute" hyperlink) (last visited Feb. 13, 2008).

11. There are important questions of what the above even means, on which I shall comment briefly below. Also, as I have already stated, and will further explain later on, there is ongoing controversy about what BITs really entail. The per-

stop governments from changing regulations, taxes, or other government policies; but they may require the government to compensate those adversely affected by the change, and in doing so, increase the cost a government will incur when it changes its regulations or other government policies. It should be clear that these agreements are not symmetric: Many government policies and investments lead to unanticipated increases in the value of assets. While companies demand compensation when a government-initiated change lowers the value of their assets, they do not offer to return to the government the increase in value from positive changes. Indeed, attempts by a government to capture an increase in value resulting from government actions might themselves be subject to investor suits, unless such recapture is guaranteed in the treaty itself.¹²

Governments, of course, are constantly changing regulations, taxes, and other policies, and making investments that have a variety of impacts on firms. The general stance of all sovereigns, especially in democracies, is that it should be the right of each government to make such changes without compensating companies. In the United States, the debate has centered on regulatory takings, with anti-environmentalists arguing for compensation.¹³ Anti-environmentalists know that by increasing the cost of environmental regulations, they will reduce their scope.¹⁴ They argue that the Con-

sistence of this ambiguity is itself a flaw, in part related to defects in the dispute resolution mechanism.

12. For instance, if a government builds a highway near a piece of land, the value of the land may increase enormously: a windfall gain for the landowner. If the government is unable to appropriate these gains for itself, it may have insufficient incentives (or resources) for undertaking such value enhancing investments. While firms insist on compensation when a government takes actions that decrease the value of their property, they are less enthusiastic about sharing the gains that arise from government actions. Investment agreements may even preclude such attempts, unless the government has imposed (in a presumably “fair and equitable” and “non-discriminatory” manner) a capital gains tax. Imposing taxes that could recapture gains would have the further advantage of discouraging lobbying (or outright corruption) to pass legislation or to make investments that increase asset values.

13. See, e.g., David Helvarg, *Legal Assault on the Environment: “Property Rights” Movement*, NATION, Jan. 30, 1995, at 126 (describing attempts by anti-environmentalists to “gut a generation of environmental laws” by supporting an act that guarantees compensation for takings under environmental laws).

14. To be fair, some advocates of regulatory takings provisions view them as not just instrumental (i.e. reducing the scope of regulatory takings will enhance

stitution protects against the arbitrary taking of property without full compensation, and contend that even takings with full compensation should be highly restricted (for example, restricted to the construction of roads).¹⁵ However, U.S. courts have consistently rejected that view.¹⁶ Indeed, in a highly controversial case, the Supreme Court extended the right of eminent domain to takings of land for developmental purposes, in which the land taken would subsequently be used by private parties.¹⁷ Disappointed with these rulings, conservatives and anti-environmentalists have turned elsewhere for assistance. In some states, anti-environmentalists have successfully lobbied to pass initiatives to provide compensation for regulatory takings,¹⁸ though such initiatives have not yet fully been tested in

economic efficiency), but believe that such provisions are necessary for a just society (it is unfair to deprive people of their property without compensation; partial deprivation through regulation is also fundamentally unfair). See Part VI for a brief discussion of regulatory takings including the Endangered Species Act of 1973.

15. Lynda J. Oswald, *Property Rights Legislation and the Police Power*, 37 AM. BUS. L.J. 527, 536-37 (2000).

16. The U.S. Supreme Court utilizes a three-prong test to analyze when government regulation constitutes a taking requiring government compensation. The Court considers three factors: “the economic impact of the regulation on the claimant . . . , the extent to which the regulation has interfered with distinct investment-backed expectations . . . [and] the character of the governmental action.” See *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124, 138 (1978) (upholding a landmark preservation law that placed restrictions on the ability of owners of landmark buildings to alter the buildings’ appearances in a number of ways). Laws and regulations that focus on restricting public nuisance and protecting the health and safety of the community have not historically required compensation. See, e.g., *Hadacheck v. Sebastian*, 239 U.S. 394, 411-13 (1915) (validating an ordinance barring brick manufacturers from residential areas); *Village of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 394-97 (1926) (ruling in favor of municipal zoning regulations for the first time and reasoning that an ordinance that restricts commercial establishments in residential areas is not arbitrary or unreasonable). Subsequently, the Supreme Court ruled that private property could be taken for public purpose rather than simply public use. *Berman v. Parker*, 348 U.S. 26, 32-34 (1954). This case led to others allowing cities to exercise eminent domain over blighted neighborhoods.

17. *Kelo v. City of New London*, 545 U.S. 469, 489-90 (2005). This much discussed case focused on the interpretation of “public use” within the context of the 5th Amendment of the U.S. Constitution. *Id.* at 490. The Supreme Court held that taking private property and transferring it to private companies for a “public use” was within the meaning of the 5th Amendment. *Id.* at 489.

18. In 2004, these regulatory takings initiatives were successful in Oregon, with the passing of Measure 37, requiring just compensation for any land use regulation passed after the statute was implemented. OR. REV. STAT. § 197.352 (2005).

state courts. Similar legislation has been introduced into Congress, but so far, such legislation has failed to pass. However, legislation requiring the Administration to provide a cost-benefit analysis of any regulatory taking has been approved.¹⁹ I was in the Clinton administration (as a member, and later, Chairman, of the Council of Economic Advisers (“CEA”)) during a period of particularly intensive efforts by some in Congress to have such legislation adopted. There was remarkable agreement among all the offices of the White House—CEA, Office of Science and Technology Policy (“OSTP”), Office of Information and Regulatory Affairs in the Office of Management and Budget, and Council on Environmental Quality. Each

In Arizona in 2006, voters overwhelmingly supported a similar measure: Proposition 207 (“Private Property Rights Protection Act”). JANICE K. BREWER, AZ SEC’Y OF STATE, PUBLICITY PAMPHLET, BALLOT PROPOSITIONS & JUDICIAL PERFORMANCE REVIEW 177 (2006), available at <http://www.azsos.gov/election/2006/Info/PubPamphlet/english/Guide.pdf>. However, initiatives failed to garner sufficient voter support in Washington, California, and Idaho. See Wash. Sec’y of State, Initiative Measure No. 933 (Wash. 2006), available at <http://www.secstate.wa.gov/elections/initiatives/text/i933.pdf>; Cal. Att’y General, Proposition 90 (Cal. 2006), available at http://www.sos.ca.gov/elections/vig_06/general_06/pdf/proposition_90/entire_prop90.pdf; Ben Yursa, Idaho Sec’y of State, Proposition 2 (Idaho 2006), available at <http://www.idsos.state.id.us/ELECT/INITS/06init08.htm> (last visited Feb. 13, 2008).

In 2006, the Oregon initiative was challenged in state court. *MacPherson v. Dep’t of Admin. Servs.*, 130 P.3d 308 (Or. 2006). Although plaintiffs’ attempts to overturn Measure 37 were successful in the lower courts, the Oregon Supreme Court found Measure 37 constitutional. *Id.* at 322.

Since *Kelo*, twenty-six states have enacted bills restricting its scope. In three states, the legislatures ratified a constitutional amendment reducing the scope of *Kelo*, and an additional two state legislatures passed bills only to have them vetoed by the governors. National Conference of State Legislatures [NCSL], State Legislative Response to *Kelo*, Annual Meeting 2006, <http://www.ncsl.org/programs/natres/annualmtgupdate06.htm> (last visited Feb. 2, 2008). For example, Illinois

[p]rohibits the use of eminent domain to confer a benefit on a particular private entity or for a public use that is merely a pretext for conferring a benefit on a particular private entity. Limits the use of eminent domain for private development unless the area is blighted and the state or local government has entered into a development agreement with a private entity.

Id. See Equity in Eminent Domain Act, S.B. 3086, 94th Gen. Assem. (Ill. 2006), for the text of the Illinois law.

19. See Omnibus Consolidated Appropriations Act of 1997, Pub. L. No. 140-208, § 645, 110 Stat. 3009 (requiring the Office of Management and Budget to prepare a detailed analysis of the costs and benefits of each regulatory action of the federal government).

office believed that such legislation would unduly circumscribe the ability to legislate needed regulations for protecting the environment, workers, consumers, and investors. President Clinton and Vice-President Gore supported this position; together, the offices of the White House successfully defeated all such efforts to compensate for “regulatory takings.”²⁰

My interest in the subject at hand arose partly because while we were successfully fighting against these regulatory takings initiatives, we were also working hard for the passage of the North American Free Trade Agreement (“NAFTA”), which, in its Chapter 11, contained language that has subsequently been interpreted, at least in some cases,²¹ as a regulatory takings provision. Had President Clinton known about this, I feel confident that he would have, at a minimum, demanded a side-letter providing an interpretation of Chapter 11 which precluded a takings interpretation. But we never had a discussion on the topic in the White House, and I am convinced that President Clinton was not aware of the risk of such an interpretation.²² In the subsequent fast track passage in Congress, Chapter 11

20. There were a series of House bills in the 109th Congress attempting to impose greater limits on eminent domain and regulation by the government. These proposals all died in the Senate. *See* Private Property Rights Protection Act 2005, H.R. 4128, 109th Cong. (2005); Threatened and Endangered Species Recovery Act, H.R. 3824, 109th Cong. (2005); Private Property Rights Implementation Act, H.R. 4772, 109th Cong. (2006).

21. Because of the one-off nature of this form of international dispute settlement, different tribunals have seemingly taken different positions and may even resolve similar cases in different ways. It is clear, for instance, from the discussion below that many investors believe that Chapter 11 provides such protection. Most arbitration panels seem, however, to be sensitive to the controversial nature of the regulatory takings/expropriations perspective, and few tribunals have found governments liable for expropriation when regulations have been at issue. It is more typical for tribunals to find some other treaty breach (failure to provide “fair and equitable treatment,” for example) than to rule that there has been an expropriation. *See* *Methanex Corp. v. United States*, Final Award, 44 I.L.M. 1345, 1457 (2005) (UNCITRAL/NAFTA, Aug. 3, 2005) (finding that U.S. methanol regulations did not constitute a regulatory taking in violation of Chapter 11). *See* IISD, *Tribunal Rejects Compensation Claim in Key Environmental Arbitration*, INV. L. & POL’Y NEWS BULLETIN (Aug. 22, 2005), http://www.iisd.org/pdf/2005/investment_investsd_aug22_2005.pdf, for a summary of the outcome in *Methanex Corp.*

22. At the time, there was considerable debate within the White House about whether to pursue the passage of NAFTA, with higher priority being assigned to domestic issues (deficit reduction, health care reform, welfare reform). It was partly at the urging of the CEA that the adoption of NAFTA was added to the list

once again was not the subject of much, if any, discussion. This highlights one of the main criticisms of these agreements—that they are, in their nature, not democratic and that, indeed, may be their main rationale: to circumvent normal democratic processes and get protections for investors that would be otherwise unattainable had there been an open and public discussion.²³ If the United States, a country with a great deal of experience adopting such agreements, was not fully aware of NAFTA's import, developing countries are even less likely to understand the complexities of such agreements.²⁴

The consequences are just becoming apparent, as the number of suits under these agreements has soared. One recent count has the

of important initiatives. I had an occasion subsequently to discuss NAFTA with Mickey Kantor, who at the time was the U.S. Trade Representative (“USTR”) and thus the person directly responsible for trade agreements like NAFTA. I asked him whether he was aware *at the time* of the full import of Chapter 11. He pointed out, rightly, that the Clinton administration had inherited the text from the George H.W. Bush administration, so besides the concerns about labor and environment that were reflected in side-letters to the agreement, little attention was paid to the details of what was actually contained in the text of the agreement. A recent article describes the public vetting: “Chapter 11 came into effect in 1994. One of the first sections of NAFTA to be completed, it was settled with little fanfare and virtually no public scrutiny.” Andrew Nikiforuk, *11 Feet Under*, *Globe and Mail* (Toronto Can.), Nov. 26, 2004, at 58. More to the point, in the same article, Abner Mika, President Clinton’s General Counsel, is quoted: “If Congress had known that there was anything like this in NAFTA, they would never have voted for it.” *Id.*

23. Others have come to similar conclusions. For instance, Mary Hallward-Driemeier states: “In addition to the size of the awards and the constraints placed on policymakers, some American critics are concerned that Chapter 11 is causing an ‘end run’ around the constitution and are decidedly antidemocratic—the terms and consequences of Chapter 11 were never publicized or debated prior to signing; that there is no room for public comment or even public scrutiny of the arbitration procedures; and limited mechanisms for appeal.” Hallward-Driemeier, *supra* note 7, at 7 n.7.

24. See, e.g., IISD, *Pakistan Attorney General Advises States to Scrutinize Investment Treaties Carefully*, INV. TREATY NEWS (Dec. 1, 2006), http://www.iisd.org/pdf/2006/itn_dec1_2006.pdf (relating the situation in Pakistan where the country, facing investor-state arbitration under its BITs, is beginning to realize the “full import” of agreements that were initially signed in haste). Interestingly, as this paper goes to press, the investment provisions of the Korea-U.S. bilateral trade agreement have become one of the major focal points of opposition. I have had discussions with very senior government officials of a small Asian country that is under pressure to sign a BIT with the United States. They too have gradually become aware of some of the problems of BITs—within the region, the experience of Indonesia, discussed earlier, seems particularly salient. They were, however, not confident that they could resist U.S. political pressure.

number of cases under arbitration as exceeding 200 since the mid 1980s—entailing claims of tens of billions of dollars.²⁵

In this paper, I want to focus on some foundational issues:

- a) Is there a need for international economic agreements concerning the regulation of MNCs?
- b) If there is, what should be the scope for such multinational agreements, and what global institutional arrangements might be most effective?
- c) In particular, should governments have the right to restrict entry of foreign corporations (as opposed to people or capital)? Should they have the right to insist on incorporation inside their own country?
- d) Who should be protected by such agreements?
- e) To what extent should property be protected from changes in regulation, taxation, or other government policies? What should be the standard of compensation?
- f) Should these agreements be more balanced, imposing responsibilities as well as rights, and enhancing the ability of host countries to impose sanctions against those that fail to live up to their responsibilities?
- g) Are there legitimate reasons for a country to discriminate between foreign and domestic firms? Should investment treaties be limited to prohibiting such discrimination? What are the costs and benefits of such a restriction?

25. See UNCTAD, *Latest Developments in Investor-State Dispute Settlement*, 1 fig.1, U.N. Doc. UNCTAD/WEB/ITE/IIT/2005/2 (2005). Although investment treaties have been negotiated since the late 1950s, there is no public evidence of their use in arbitrations prior to the mid 1980s. Two cases alone—those by the majority shareholders of Yukos Corporation against Russia and those by disgruntled bondholders against Argentina—involve claims of more than one billion dollars each. See *id.* at 6 (noting that the shareholders of the Yukos Corporation mounted three arbitrations for a total of \$33 billion); Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, 6 CHI. J. INT'L L. 311, 317 (2005) (referring to the Argentine case as the “largest and potentially most complex default the world has ever known,” beginning at \$60 billion and growing to a default of more than \$105 billion). See Alan Beattie, *From a Trickle to a Flood: How Lawsuits are Coming to Dictate the Terms of Trade*, FIN. TIMES, Mar. 20, 2007, at 13, for a discussion of the exponentially increasing role of litigation in addressing trade disputes, specifically at the WTO.

- h) If the requisite global institutional arrangements cannot be created (at least in the short run), what can or should individual countries do?
- i) When there are disputes—as there inevitably will be—how should such disputes be resolved?

The entire discussion is informed by modern economic theory, which has helped clarify the role of markets and of government, including the importance, and limitations, of property rights. In this sense, this paper is a contribution to the general theory of law and economics, but it is based on foundations that are markedly different from the predominant Chicago School of Law and Economics.²⁶ The last quarter century has seen a re-examination and a rejection of the economic foundations on which that theory rests, and the creation of a new paradigm, based on imperfect information and incomplete markets. In this new paradigm,²⁷ markets by themselves are not, in general, efficient, and government intervention—sometimes even

26. The theories of the Chicago School of Law and Economics have been most forcefully articulated in the works of Richard Posner. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (7th ed. 2007); RICHARD A. POSNER, *LAW AND ECONOMICS* (Richard A. Posner & Francesco Parisi eds., 1997) (providing a detailed discussion of the School which views legal institutions as part of a system designed to ensure efficiency, promoted most effectively through free market competition combined with secure property rights). The School typically also perceives that there are strong economic forces that can maintain competition (so, for instance, there is little need for anti-trust action). For example, even when there is a natural monopoly—a single firm dominates the market because of increasing returns to scale—competition for the market, to be that single firm—is so strong that efficiency is ensured. See WILLIAM J. BAUMOL ET AL., *CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE* 215 (1982). Like much of the rest of this theory, it rests on weak foundations: If there are even arbitrarily small sunk costs, then markets are not contestable; potential competition does not suffice to ensure economic efficiency. See, e.g., Joseph Farrell, *Cheap Talk, Coordination and Entry*, 18 *RAND J. ECON.* 34, 34 (1987); Joseph E. Stiglitz, *Technological Change, Sunk Costs, and Competition*, 1987 *BROOKINGS PAPERS ON ECONOMIC ACTIVITY* 883, 890-93 (1987); P. Dasgupta & J.E. Stiglitz, *Potential Competition, Actual Competition and Economic Welfare*, 32 *EUR. ECON. REV.* 569, 571-72 (1988).

27. See Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, in *LES PRIX NOBEL; THE NOBEL PRIZES 2001* (Tore Frangsmyr ed., 2002); Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, 92 *AM. ECON. REV.* (2002) (abbreviated version) [hereinafter Stiglitz, *Paradigm in Economics*]. See Part III.A.1 for a more extensive discussion of the limitations of the “old” paradigm.

quite limited interventions, such as circumscribing conflicts of interests, as in the case of auditing²⁸—can lead to welfare improvements.²⁹ Laws and regulations are, however, not only directed at improving efficiency, but also at promoting social justice more broadly defined, including protecting those who might otherwise not fare so well in the market economy if left to themselves. This helps explain legislation and regulation designed to protect consumers, workers, and investors. In addition, there are some areas in which rules are essential: Every game, including the market game, requires rules and referees. There may be more than one set of “efficient” rules, but different rules have different distributional consequences. Society, in selecting a set of rules to regulate economic behavior, has to be mindful of these distributional consequences.

In the international setting, seemingly symmetric (or “fair”) rules or agreements may have asymmetric (or “unfair”) effects, because of the differences in the circumstances of the countries to which they

28. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 § 201 (codified as amended in scattered sections of titles 11, 15, 18, 28, and 29 of the United States Code) [hereinafter SOX]. Section 201 concerns what other business an auditor can perform with a company he audits, and specifically prevents auditors from providing the “issuer, contemporaneously with the audit, any non-audit service.” *Id.*

29. This revisionist view has also changed perspectives on other non-market institutions. Previously, some had argued that non-market institutions arose to address market failures. *See, e.g.*, DOUGLASS C. NORTH, *STRUCTURE AND CHANGE IN ECONOMIC HISTORY* (1981). For instance, because of moral hazard, markets provide only limited insurance, and gaps in market insurance are filled, in part, by non-market institutions, like families. Putting aside the functionalist fallacy, a closer analysis of the interactions between these non-market institutions and markets shows that they may, in fact, be dysfunctional. That is, while they may arise to fill in holes left by the market, markets respond to these non-market institutions, with the net result that the overall level of insurance, and economic welfare, may be decreased: The non-market institutions that are less efficient in risk-sharing than the market institutions; and the non-market institutions crowd out the market institutions. *See* Richard Arnott & Joseph E. Stiglitz, *Moral Hazard and Nonmarket Institutions: Dysfunctional Crowding Out or Peer Monitoring*, 81 AM. ECON. REV. 179 (1991). Mr. North’s more recent works seem to reflect recognition of the limitations in the earlier view. *See, e.g.*, DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE* (1990); DOUGLASS C. NORTH, *UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE* (2005); Joseph E. Stiglitz, Keynote Address: Challenges in the Analysis of the Role of Institutions in Economic Development, in VILLA BORSIG WORKSHOP SERIES 2000: THE INSTITUTIONAL FOUNDATIONS OF A MARKET ECONOMY 15-28 (DSE 2001).

apply. This includes differences in their political or economic powers in enforcement, or their ability to use political powers to extract further terms in another context. When Antigua won a major battle against U.S. restrictions on on-line gambling in the World Trade Organization (“WTO”), there was no means by which it could effectively enforce it: Imposing trade sanctions would have hurt Antigua far more than it would have hurt the United States. In contrast, had Antigua engaged in an unfair trade action against the United States, any sanctions granted to the United States against Antigua would have been powerful.³⁰ As another example, after developed and developing countries have agreed to a trade liberalization agreement, for instance, the International Monetary Fund (“IMF”) and the World Bank may insist that the developing country engage in further liberalization, if it is to receive a requested grant or loan.³¹ A drug company in the United States will induce the U.S. government to pressure a foreign country considering a compulsory license requirement not to do so, even when the issuance of that license is totally within the framework of the WTO. This implies that one cannot look at the reasonableness of any particular agreement in isolation from a broader context—or even assess its true impact.

This paper looks at the laws relating to corporate governance and bankruptcy through this perspective. We argue that even a narrow focus on efficiency requires going beyond frameworks that ensure shareholder value maximization, but that when a broader perspective incorporating equity as well as efficiency is taken into account, the case for alternative frameworks becomes even more compelling. We argue that BITs may interfere with a country’s ability to develop a legal framework maximizing society’s social welfare.

We view BITs through two different lenses—as imposing *restrictions* on the ability of governments to impose certain regulations (or to change certain policies), and as providing *insurance* to those establishing businesses within a jurisdiction against losses that might occur in the event of such changes. Imposing restrictions on their be-

30. See STIGLITZ & CHARLTON, *supra* note 5, at 77 (highlighting the disparity between the bargaining powers of developed and developing countries). This particular problem could be remedied by allowing trade sanctions to be marketable.

31. Risa L. Lieberwitz, *Linking Trade and Labor Standards: Prioritizing the Right of Association*, 39 CORNELL INT’L L.J. 641, 645 (2006).

havior may reduce regulatory uncertainty (although at a high cost), but it may not be the best way to reduce risk. As an alternative, should the market provide insurance? Normally, free market advocates view markets as more efficient than government in providing insurance. Is there a rationale, in this case, to rely on publicly provided insurance? We will argue, however, that the way that most BITs have been designed may actually be increasing at least some aspects of risk: If risk mitigation were their primary objective, they have failed to do so in either an efficient or fair way.

A. BASIC PERSPECTIVES

The basic perspective I take in this paper is the following: It is hard to think of a successful U.S. economy, and impossible to deal with cross-border disputes, with only state laws. We have developed a finely honed system (although not without its flaws) defining what states may do. The system is designed to ensure that states do not interfere with interstate commerce and that they do not give business privileges to their residents at the expense of outsiders, but, at the same time, to provide them latitude to pass regulations and laws to protect their citizens. A host of complicated issues are raised: Do minimum wage laws interfere with interstate commerce or otherwise restrict basic rights? Do state environmental laws do so? There is, implicitly, a careful balancing. Obviously, any law can affect commerce, and any law restricts actions which individuals might otherwise undertake. Clearly, laws *designed* to interfere with interstate commerce are not allowed, but how far can or should one go in striking down laws for which this is an incidental effect? Should it be a matter of principle, which might, for instance, restrict *any* minimum wage legislation or *any* labor legislation? Or should it be a matter of judging the magnitude of the effect? Similar questions arise in assessing whether such laws violate basic rights to contract. As we debate the question inside the United States, there are democratic processes at play at all levels. In principle, if states are enjoined from passing minimum wage laws, then the federal government might be able to do so. This is also true for other types of regulation. However, a regulatory gap may arise when a higher level body imposes restric-

tions on a lower level authority when the higher level authority does not have the right to take action.³²

Similarly, as we move to a global economy, we will need to have legal frameworks governing cross-border disputes. There will be a need to assess what regulations constitute an unfair restriction on trade. But unfortunately, economic globalization has outpaced political globalization: We have not developed the requisite democratic international institutions, either for drafting agreements or adjudicating disputes. The international agreements in existence, for instance, in trade are the result of hard bargaining behind closed doors, with the concerns of special interests in the large and economically dominant countries (Europe and the United States) prevailing.³³

BITs and the investment provisions of FTAs have attempted to fill in the gap, but they have done so in a way that is far from satisfactory. They are based on an incoherent set of economic principles, which leads to a failed understanding of the appropriate role of national regulation. We argue further that there is a fundamental difference between the rights of labor and capital to move across borders and the rights of a corporation incorporated in one jurisdiction to operate in another. It is a legitimate prerogative of governments to require that those wishing to engage in material business within their borders be incorporated—for example, through the establishment of

32. The Supreme Court concluded that the U.S. Constitution prohibited state minimum wage laws as interfering with interstate commerce or interfering with the basic freedom to contract but did not give the federal government the power to pass such laws. *See* *Lochner v. New York*, 198 U.S. 45, 62-64 (1905) (finding that a maximum number of hours law impinged on the liberty of the individual to contract); *Adkins v. Children's Hospital of D.C.*, 261 U.S. 525, 539, 562 (1923) (finding that federal minimum wage legislation for women was unconstitutional). The former was eventually overturned. *See* *West Coast Hotel Co. v. Parrish*, 300 U.S. 379, 399-400 (1937) (allowing states to pass minimum wage laws, specifically regarding women and children). The possibility of the creation of a "no man's" land is of particular concern in globalization. At least within the United States, there are relatively simple ways of addressing a problem posed by such gaps.

33. There are many examples where the USTR pushed for policies that increased the profits of certain corporate interests even though they were against the broader interests of the United States. *See* STIGLITZ, *supra* note 1, at 116 (providing, as an example of corporate interests trumping those of the United States and of developing countries, the influence of the drug and entertainment industries over the USTR that led to U.S. negotiations for excessively strong intellectual property rights).

a subsidiary—within the country. As the discussion below will make clear, however, these requirements are necessary, but not sufficient: There are far deeper problems with the investment agreements.

One of the problems of BITs is that they are one-sided and unbalanced: They give corporations rights without responsibilities, compensation for adverse treatment, but not recovery of capital gains from positive treatment. They also provide foreign firms protections not afforded to domestic firms, thereby creating an unlevel playing field, with perverse incentives.³⁴ There are good reasons that governments have not provided these guarantees to domestic firms—and there are good reasons that they should not be provided to international firms.

I approach these issues from the perspective of an economist, an economist that sees institutions like “corporations” and “property rights” as social constructions, to be evaluated on how well they serve broader public interests. Individuals have rights—the kinds of rights inscribed in the Bill of Rights. Individuals may have certain rights to act together collectively, but there is no inherent right, for instance, to limited liability, which defines corporations. Limited liability is a social construction which has proven very useful; indeed, without it, it would be hard to imagine modern capitalism.³⁵ But the circumstances in which the corporate veil can be pierced, the “rights” which ought to be granted to these limited liability institutions (including the right to enter a country), or the extent to which the officers of these institutions should be held liable for the actions which

34. Concern about this has led the United States, in the recent Korea-U.S. FTA, to include provisions which ensure that Korean investors in the United States do not have more rights and protections than U.S. investors. Office of the U.S. Trade Representative, Korea-United States Free Trade Agreement, art. 2.2, available at http://www.ustr.gov/Trade_Agreements/Bilateral/Republic_of_Korea_FTA/Final_Text/Section_Index.html (last visited March 2, 2008).

35. See B. Greenwald & J. E. Stiglitz, *Information, Finance and Markets: The Architecture of Allocative Mechanisms*, 1 INDUS. & CORP. CHANGE 37, 60 (1992) (identifying limited liability and enforceable fraud standards as contributing to the success of modern economies by ensuring “trustworthy” enforceable contracting and enabling the agglomeration of capital from many individuals who did not know each other or their balance sheets).

these institutions take, is a matter of economic and social policy. To repeat, corporations have no inherent rights.³⁶

Thus, an analysis of the desirability of extending to corporations certain rights is quintessentially a matter of economic and social analysis—to ascertain what are the consequences of one set of provisions or another. The intent of this paper is to provide this analysis.

Readers will see a close parallel between the approach taken here and that taken by Adolf A. Berle and Gardiner C. Means in their classic work, *The Modern Corporation and Private Property*.³⁷ They called attention to the separation of ownership and control and explored the implications for property rights. My 1985 paper helped put Berle and Means on solid footings; using new understandings from the economics of information, it provided the theoretical foundations for the separation of ownership and control and helped explain why effective control is not exercised by shareholders.³⁸ It also helped begin the modern discussion of corporate governance.³⁹

36. I take this view, recognizing that some have argued that corporations do enjoy some protection under the U.S. Constitution. See *Santa Clara County v. S. Pac. R.R. Co.*, 118 U.S. 394 (1886) (arguably granting 14th Amendment due process protection to corporations).

37. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (Harcourt, Brace & World, Inc. 1967) (1932).

38. The problems are related not only to imperfect, asymmetric, and costly information, but to the fact that good management of a firm is a public good (in the technical, Samuelsonian sense): All shareholders benefit if firm profits increase as a result of better management. As a public good, there will be an undersupply of oversight of corporate management. Joseph E. Stiglitz, *Credit Markets and the Control of Capital*, 17 *J. MONEY, CREDIT & BANKING* 133, 136 (1985) [hereinafter Stiglitz, *Credit Markets*].

39. Earlier, I had explored limitations on alternative mechanisms for corporate control, such as takeovers. See, e.g., Joseph E. Stiglitz, *Some Aspects of the Pure Theory of Corporate Finance: Bankruptcies and Take-Overs: Reply*, 3 *BELL J. ECON.* 458, 473-80 (1972) [hereinafter Stiglitz, *Bankruptcies and Take-Overs*] (analyzing the implication of takeovers on a firm's financial policy and limitations in the takeover mechanism); Joseph E. Stiglitz, *Ownership, Control, and Efficient Markets: Some Paradoxes in the Theory of Capital Markets*, in *ECONOMIC REGULATION* 311, 324-31 (Kenneth D. Boyer & William G. Shepherd eds., 1981) [hereinafter Stiglitz, *Paradoxes*] (discussing shareholder meetings, takeovers, "voting with dollars," and evolutionary processes as imperfect mechanisms for ensuring efficient behavior of managers). See Aaron S. Edlin & Joseph E. Stiglitz, *Discouraging Rivals: Managerial Rent-Seeking and Economic Inefficiencies*, 85 *AM. ECON. REV.* 1301 (1995) (demonstrating how managers can ensconce themselves and act in ways that are not in the interests of shareholders); see also Sanford

One more preliminary caveat: The problems with the BITs is that they invoke inherently ambiguous terms (“fair and equitable treatment”); the adjudication process often invokes standards of commercial secrecy, even though one of the parties to the suit is a public entity in which there should be high standards of transparency; different arbitration panels can come to opposite conclusions in almost identical cases;⁴⁰ and there is typically no way in which such differences get resolved. Since a large fraction of the agreements are of recent vintage, there is considerable uncertainty about what they may imply. In the long run, greater balance may be achieved than has sometimes been the case in the past;⁴¹ and the fears expressed here may prove unwarranted. Part of the intent of this paper is to influence the evolution of this critical area of law.

Part II of this paper provides a brief reprise of the important contributions of MNCs—and the special problems they pose, problems that may be somewhat different from those posed by domestic firms.

Grossman & Oliver Hart, *Takeover Bids, The Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42, 47-50 (1980) (discussing the tendency of managers to choose a course of action leading to higher managerial utility over a course of action likely to produce a high profit and avoid takeover).

40. Compare *LG&E Energy Corp.*, ¶ 226, 46 I.L.M. at 68 (finding that a “state of necessity” existed in Argentina from December 2001 until April 2003, thereby excusing Argentina from performance under a BIT during that time period), with *CMS Gas Transmission Co.*, Award, *supra* note 10, ¶ 331, 44 I.L.M. at 1241 (rejecting Argentina’s assertion that a “state of necessity” existed during a similar time period), *CME Czech Rep. B.V.*, Partial Award, *supra* note 10, ¶ 624 (granting a partial award to CME after finding that the Czech Republic had violated its obligation of “fair and equitable treatment” following a change in the Czech media laws), and *Lauder*, *supra* note 10, ¶ 295 (failing to find a breach of a duty to accord “fair and equitable treatment” under similar circumstances). See August Reinisch, *Necessity in International Investment Arbitration – An Unnecessary Split of Opinions in Recent ICSID Cases?*, 8 J. WORLD INV. & TRADE 191 (2007), for a discussion of the former set of cases and how inconsistent decisions threaten to undermine the arbitral process.

41. As already noted, the Korean-U.S. BIT attempts to address the problem of foreign investors having greater protections than domestic investors. It also seems to ensure that there is more transparency in the arbitration process. Other agreements subsequent to NAFTA have attempted to limit the extent to which such provisions can inhibit environmental regulations. Whether these modifications produce the benefits alleged has yet to be fully tested; while there have been some procedural reforms under NAFTA (for example, concerning transparency), many of the problems cannot be addressed without the cumbersome process of treaty renegotiation—again, a central objection to these agreements—or the voluntary agreement of all parties.

It describes the benefits MNCs have brought, but also explains why they have been subject to such criticism. Part III provides the core of the economic analysis. It articulates the market fundamentalism position underlying many of the arguments of free market advocates, including those stressing the importance of property rights protection (sometimes referred to as the Chicago School). Part III explains (a) why under those perspectives there would be no need for bilateral trade agreements; but (b) why these ideas have been rejected by modern economic analysis. On the basis of this, it explains why government regulation is required and applies that analysis to explain the need for government rules governing corporate governance and bankruptcy.

A key question is whether there is a single “best” set of legal institutions—for instance, a single Pareto Optimal⁴² set of corporate governance and bankruptcy laws. If there is, then it would make sense to standardize legal frameworks. In Part IV, I explain why there is not a single Pareto dominant legal framework, and accordingly why standardization may be undesirable.⁴³

The following sections then apply this analysis to several of the central issues under dispute in the controversy over investment treaties: What rights should foreign firms have to establish themselves? Part V argues against even the limited rights to establishment embodied in many of the recent investment treaties. But the various problems with BITs will not be solved merely by requiring foreigners to incorporate local subsidiaries in the host state. Rather, the treaties themselves need to be restructured.⁴⁴ Who should be pro-

42. A law (or resource allocation) is said to be Pareto Optimal if there is no other law (or resource allocation) such that everyone is better off. STIGLITZ & CHARLTON, *supra* note 5, at xxiv. If there is a single Pareto Optimal legal structure, then presumably there will be unanimity in support; but if there are multiple Pareto Optimal legal structures, there will be trade-offs, with some individuals better off under one, others under another.

43. There may, of course, be efficiency gains from standardization; but these efficiency gains need to be compared with the efficiency losses—the standardized rules may be less suited to the economic situation of some, or all, of the countries than a more tailored set of rules. There may be large distributive consequences that more than offset the efficiency gains—the standard may be tailored to provide advantages to the rich and powerful, to the disadvantage of others.

44. Indeed, many of the foreign investment disputes involve a local subsidiary incorporated in the host state where the foreign parent invokes international treaty

tected and against what “measures” (actions)? With what “standards?” For instance, should there be protection simply against discrimination, or against actions that are inconsistent with principles of “fair and equitable?” If the latter, what is to be meant by such words? What should be the standard of compensation?

There is little dispute about the issue of protection from explicit expropriation.⁴⁵ Part VI looks at one of the critical ways that BITs go well beyond protecting against expropriation, to protecting against changes in regulations—or even the effect of existing regulations. We argue that such protections can undermine economic efficiency and can be contrary to basic principles of social justice, particularly given the standards that have sometimes been invoked.

Of course, the bilateral agreements do not prohibit governments from undertaking various actions; they simply require the government to provide compensation. But for cash strapped governments, the effect may be much the same. Part VII addresses the issue of compensation, arguing strongly against the broader compensation sometimes required (which includes lost profits⁴⁶), but also suggesting that even compensation for reduced value of investments may be problematic.

rights in an effort to get better treatment for its investments in the host state. *See, e.g., CME Czech Rep. B.V. v. Czech Rep., Final Award*, ¶¶ 1-4, 42 I.L.M. 919, 920-21 (UNCITRAL, Mar. 14, 2003) (establishing that CME initiated arbitration proceedings under a treaty between the Netherlands and the Czech and Slovak Federal Republic to assert claims against a Czech television station in which it held a 99% interest).

45. Developing countries for a long time resisted any formal commitment not to expropriate, opposing, for instance, the Hull Rule, named after Secretary of State Cordell Hull. *See* Andrew T. Guzman, *Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639, 641 (1998) (explaining that the Hull Rule is customary international law requiring “prompt, adequate, and effective” payment when a host state expropriates a foreign corporation’s property); HENRY J. STEINER ET AL., *TRANSNATIONAL LEGAL PROBLEMS*, 456-57 (4th ed. 1994) (providing the text of the letter sent from Secretary of State Hull in 1938 to the Mexican Ambassador requesting “prompt and just compensation” for property taken from U.S. citizens by the Mexican government). Investment treaties typically do not prohibit expropriation, but only commit expropriating governments to providing compensation. This focuses attention on the issue of the bases of compensation. *See infra* Part VII.

46. *See* Aglionby & Hidayat, *supra* note 10, at 16 (citing an award by a Swiss arbitration panel granting a private party \$150 million for lost future profits).

Part VIII argues that the investment agreements have been one-sided, that they have given foreign companies rights without imposing responsibilities, or without even facilitating the ability of developing countries to ensure that the MNCs live up to their obligations.

One of the most criticized aspects of these agreements is the dispute resolution mechanisms: the use of arbitration courts, designed to settle commercial disputes, to enforce an agreement where a sovereign is a party. The processes often lack the openness and transparency that we have come to expect from judicial proceedings in a democratic society and have shown little regard to broader societal concerns, as they focus exclusively on the rights of investors. Part IX argues that there is much merit in these criticisms and proposes reforms in the adjudication process, including the creation of an international commercial court.

The problems in regulation uncovered in previous sections highlight the need to improve the international framework that governs cross-border economic activities, a subject addressed in Part X. Part XI emphasizes two core principles: (a) minimizing the scope of such agreements to standards that are viewed as absolutely essential for the conduct of cross-border business; and (b) non-discrimination.

The next sections discuss two of the key criticisms of the bilateral agreements: They are not designed in ways that make the appropriate legal evolution possible. It is difficult to correct “mistakes” either in the design of the treaties or the interpretation of the provisions—further reinforcing the argument for a limited scope for such agreements. Furthermore, the political processes underlying these investment agreements are fundamentally undemocratic.

The final section provides concluding remarks: Balance needs to be restored to the governance of cross-border economic relations. Countries should be extremely cautious in signing BITs, especially the more expansive agreements that go beyond non-discrimination. It also provides support for the initiatives of several countries, such as Ecuador, Bolivia, and the Czech Republic, for revising existing agreements. Finally, there needs to be a serious rollback in the agreements already in force.

II. PROBLEMS POSED BY MULTINATIONAL CORPORATIONS

For all the reasons given earlier, multinationals have brought enormous benefits. Today, countries around the world compete to attract multinationals; they boast of having a business-friendly environment. Furthermore, foreign capital has poured into developing countries, increasing six fold between 1990 and 1997, before it slowed (and reversed) as a result of the East Asian and global financial crisis.⁴⁷

But for all the benefits they bring, MNCs have been vilified—and often for good reason. In some cases MNCs take a country's natural resources, paying but a pittance while leaving behind an environmental disaster.⁴⁸ When called upon by the government to clean up the mess, the MNC announces that it is bankrupt: All of the revenues have already been paid out to shareholders. In these circumstances, MNCs are taking advantage of limited liability.⁴⁹

In some cases, when the adverse consequences of their actions are criticized, MNCs plead that they are simply following the law; but such defenses are disingenuous for they often work hard to make sure that the law suits them well.

Consider, for instance, the regulation of cigarettes. We—and I include in the “we” the cigarette companies—have known for decades that cigarettes are bad for one's health, but the cigarette companies have deliberately tried to create confusion about the scientific evi-

47. UNCTAD provides data on FDI flows to developing countries. In constant value terms (U.S. \$2,000), net FDI flows to developing countries (inflows less outflows) in 1990 were \$29.2 billion. This rose to \$163.3 billion in 1999, an increase of 5.6 times. Net flows remained below this level until 2005. Since then they have increased to \$176.9 billion, an increase of eight percent from 1999 levels.

48. See, e.g., JARED DIAMOND, *COLLAPSE: HOW SOCIETIES CHOOSE TO FAIL OR SUCCEED* 454 (2006) (documenting environmental problems caused by foreign-owned mines on New Guinea); see also STIGLITZ, *supra* note 1, at 141 (noting that the economic benefits of mining operations may be offset by harm to other sectors caused by environmental degradation).

49. This is true in both developed and developing countries. See DIAMOND, *supra* note 48, at 456 (citing the example of Pegasus Gold, a Canadian mining company that used the corporate veil to avoid liability for costs associated with environmental clean-up at one of its operation sites).

dence.⁵⁰ While the cigarette companies have worked hard to prevent regulation, they have also succeeded in making sure that they do not bear any liability for the enormous costs that result from their dangerous products.⁵¹

In developing countries, there are widespread allegations of corruption—and many contracts that only make sense when seen in that context. For years, many countries provided tax deductions for bribes; in effect, Western governments were subsidizing them, even though they undermined democratic governance abroad (and even as they lectured them about the importance of democratic governance).⁵² I was the U.S. representative to the OECD ministerial meeting in the mid-1990s, when the United States was pushing for the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.⁵³ I was shocked by the resistance. The problem is more pervasive. Companies like BP and Hydro, that have made an effort to make their transactions more transparent, have not always found support among their colleagues.⁵⁴ This puts the “good guys” at a competitive disadvantage.

50. See, e.g., *United States v. Phillip Morris USA Inc.*, 477 F. Supp. 2d 191, 197 (D.D.C. 2007) (commenting that “the [Defendant’s] activities . . . were all devoted to advancing and furthering . . . efforts . . . to mislead and deceive American smokers and potential smokers about the . . . health risks of . . . cigarettes”); see also *Schwab v. Philip Morris USA, Inc.*, 449 F. Supp. 2d 992, 995 (E.D.N.Y. 2006), *overruled by* *McLaughlin v. Am. Tobacco Co.*, 2008 U.S. App. LEXIS 7093 (2d Cir. 2008).

51. More recently, Exxon has engaged in a similar attempt to discredit the science of global warming. When British Petroleum (“BP”) owned up to the risks of global warming, it was castigated by the other members of the oil club, and treated as a pariah for some time. See Jeffrey Ball, *Exxon Softens Climate*, WALL ST. J., Jan. 11, 2007, at A2 (“[Exxon’s] top executives have openly questioned the scientific validity of claims that fossil-fuel emissions are warming the planet, and it has funded outside groups that have challenged such claims in language sometimes stronger than the company itself has used.”). For instance, until 2005, Exxon funded the Competitive Enterprise Institute, a Washington-based think tank that ran television ads maintaining that carbon dioxide (the main greenhouse gas) is helpful. *Id.*

52. See John B. Bellinger, III, *Reflections on Transatlantic Approaches to International Law*, 17 DUKE J. COMP. & INT’L L. 513, 516 (2007) (noting that European companies took advantage of such tax breaks).

53. Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Dec. 18, 1997, 37 I.L.M. 1 (1998).

54. See Nicholas Shaxson, *BP to Give Details of Angola Operations*, FIN. TIMES, Feb. 21, 2001, at 29 (documenting BP’s announcement that it would dis-

A. WHY FOREIGN MULTINATIONALS MAY PRESENT A WORSE PROBLEM THAN DOMESTIC CORPORATIONS

The problem of corporations taking advantage of limited liability to escape, for instance, responsibility for their environmental damage,⁵⁵ and using their enormous financial powers to frame legislation to their advantage, arises with domestic corporations as well. What then is distinctive about MNCs?

First, the economic powers of MNCs are huge—often far larger than that of the countries with which they are dealing. The annual revenues of General Motors are greater than the GDP of more than 148 countries;⁵⁶ while Wal-Mart's revenues exceed the combined GDP of sub-Saharan Africa, excluding South Africa and Nigeria.⁵⁷ It is an unfair playing field. Not surprisingly, MNCs often wield their economic power to create an uneven playing field in order to gain special tax or regulatory treatment.

Sometimes, MNCs do this in ways that are above board, such as through campaign contributions (which have proven so corrosive of democratic processes even in strongly established democracies, such as the United States, but whose adverse effects are even greater in the nascent democracies of much of the developing world). Sometimes, MNCs exert their influence simply by threatening to leave the

close payments it made to the Angolan government). The government responded by threatening to demand that BP leave; the other oil companies quickly went along with the demands of the government. See Harriet Fletcher, *Corporate Transparency in the Fight Against Corruption*, in GLOBAL CORRUPTION REPORT 2003, at 33, 37 (Robin Hodess et al. eds., 2003) (insinuating that oil companies acceded to the Angolan government's wish to keep secret payments made in order to protect their investments).

55. See DIAMOND, *supra* note 48, at 428 (documenting the situation of mining companies in Montana that declared bankruptcy and left taxpayers with the costs of rectifying environmental degradation).

56. Compare Bill Vlasic, *GM Offers New Buyout to 74,000*, N.Y. TIMES, Feb. 13, 2008, at C1 (announcing that GM had \$206 billion in total revenue in 2006), with WORLD BANK, WORLD DEVELOPMENT INDICATORS DATABASE: TOTAL GDP 2006, available at <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (listing the GDP of 150 countries as less than \$208 billion in 2006).

57. Walmart's Revenues in 2006 were over \$351 billion. *2007 Fortune 500*, FORTUNE MAGAZINE (Apr. 30, 2007). The GDP in current US dollars of sub-Saharan countries, excluding Nigeria and South Africa, was \$333 billion. WORLD BANK, WORLD DEVELOPMENT INDICATORS (2007).

country and go elsewhere if environmental or worker safety regulations are enforced or if they are asked to pay their fair share of taxes. The asymmetries in liberalization—with capital markets being far more liberalized than labor markets—have enhanced the effectiveness of such threats. But sometimes MNCs engage in corruption (bribery): The developing countries with which they deal are often weak, and salaries of government officials are generally very low, making these countries particularly susceptible to corruption.

Secondly, these MNCs often leverage their own economic power with the power of their governments, to ensure even better terms. A U.S. pharmaceutical company will pressure the U.S. government to compel a foreign country to reconsider issuing a compulsory license, even when the issuance of that license is within the framework of the WTO.⁵⁸ Aid-dependent countries are particularly susceptible to such political pressures because there is always a (veiled or overt) threat to reduce monetary assistance necessary for survival.⁵⁹ Furthermore, MNCs will pressure their governments to renegotiate a money-losing contract, as a result of underbidding (as was the case of some of Argentina's water concessions), but will not offer to renegotiate when contract shows excessive profits as a result of overbidding.⁶⁰ Western governments put pressure to force renegotiations even when there is evidence that profits are exorbitant as a result of corruption (as in the case of Suharto's Indonesian contracts).⁶¹ Corruption does not, how-

58. This was the case with the recent issuance of a compulsory license by the Thai government for an AIDS medication. See Harish Mehta, "Cheap Life-Saving Drugs: Thailand Shows the Way; Bangkok's Move Wins Praise from UN and Health Groups but Flak from Western Drug Firms," *BUS. TIMES* (Sing.), Oct. 18, 2007.

59. This is also a concern where developed countries grant "voluntary" trade preferences to developing countries that can be withdrawn almost at will (for example, under the system of Generalized System of Preferences). STIGLITZ & CHARLTON, *supra* note 5, at 100.

60. Pressure for renegotiation is often done behind closed doors, and is therefore difficult to document. As Chief Economist of the World Bank, however, I saw ample evidence that this was occurring.

61. While the United States strongly criticized the amount of corruption under Suharto's regime, the U.S. Ambassador insisted that contracts negotiated during his reign should nonetheless be honored after his departure. The Ambassador was later rewarded by being named to the board of one of the U.S. mining companies whose contracts might otherwise have been contested. In some cases, the terms of the contracts are so unfavorable to the developing country that the only plausible explanation is that of corruption. See, e.g., STIGLITZ, *supra* note 1, at 258 (describ-

ever, appear to be limited to developing countries. In more than one case, the Western ambassadors that pressure developing countries not to renegotiate a contract are named to the boards of directors of the Western companies whose interests they served.

Thirdly, sometimes MNCs take advantage of the lack of administrative capacities and technical expertise in developing countries to get away with things that they could not get away with in developed countries. Of course, MNCs attempt this tactic even in developed countries. Several oil companies systematically cheated on their contracts with Alaska, hoping that shaving off just a few pennies on every barrel of oil would not be detected; but a few pennies a barrel multiplied by billions of barrels adds up.⁶² Through sophisticated detection techniques, costing millions of dollars, the delinquent oil companies were caught; the oil firms eventually agreed to collectively pay more than a billion dollars to Alaska.⁶³ This was not the only such case. Exxon similarly cheated on its contract with Alabama,⁶⁴ assuming again that it could just get away with it.⁶⁵ But if the

ing Enron's electricity contracts in India that guaranteed a profitable price for electricity regardless of market conditions); Aglionby & Hidayat, *supra* note 10, at 16 (reporting on the Karaha Bodas case in Indonesia where a U.S. investor expected to receive (in present discount value terms) a pure profit of \$150 million on an investment of only \$111 million).

62. See Jesus Sanchez, *Arco Agrees to Pay \$285 Million to End Alaskan Dispute*, L.A. TIMES, Sept. 13, 1990, at D1 (documenting the out-of-court settlement between one oil company and Alaska resolving a claim that the company "undervalued the crude oil [it] pumped . . . thus avoiding taxes and royalty payments").

63. I was an expert witness in the case. See STIGLITZ, *supra* note 1, at 140, for a brief discussion of the tactics oil companies employed to avoid payment.

64. See *Exxon Mobil Corp. v. Alabama Dep't of Conservation & Natural Res.*, 2007 Ala. LEXIS 232, *60 (Ala. Nov. 1, 2007) (holding that Exxon owed Alabama more than \$50 million in damages for failing to accurately calculate royalties).

65. In the post-Iraq war years, it was observed that U.S. government royalties from oil and gas did not seem to increase commensurately with the rest of the market. It was made public that the oil contracts were secret and contained provisions preventing their disclosure, even by the U.S. government. It subsequently was revealed that an "error" had been made in the signing of the contract, which allowed the oil companies to receive a larger fraction of the increase in prices than they would normally have been allowed. Not surprisingly, some suspected foul play. See Edmund L. Andrews, *U.S. Royalty Plan to Give Withdrawal to Oil Companies*, N.Y. TIMES, Feb. 14, 2006, at A1 (indicating that the Government Accountability Office commenced an investigation into the oil contracts); see also Edmund L. Andrews, *Interior Dept. Near 2 Pacts on Leases for Oil Drilling*, N.Y. TIMES,

oil companies attempt to get away with such practices in the United States, what must be the case in developing countries?

Worse still, some MNCs are exploiting the lack of administrative capacity as the basis of claims *against* developing countries under BIT provisions providing for “fair and equitable treatment”—even though they should have been fully aware of these limitations at the time they made the investments. Arbitration panels have found governments liable for not providing “fair and equitable treatment” by virtue of not offering foreign investors an administrative apparatus that is sufficiently transparent, competent, responsive, and efficient. The panels have set the bar for developing countries very high.⁶⁶

Fourthly, sometimes MNCs, and the governments of developed countries who represent their interests, take advantage not only of asymmetries of power,⁶⁷ but also of information. The United States has bargained with dozens of countries. It is familiar with provisions that may have large effects, either in terms of benefits or costs. The United States has a large staff that can write, review, and analyze such agreements clause by clause. As if these advantages were not sufficient, the United States is assisted by well-paid corporate lobbyists and lawyers, who are even more sensitive to the consequences of each provision. Because of the size of its economy, the United States has virtually every industry that might be affected by the agreement, and they are, in effect, at the bargaining table. In contrast, developing countries have a small staff. At stake are not simply the industries present during negotiations, but also those that might be established in the future. These industries have neither lobbyists nor lawyers to represent their interests. Even if a developing country realizes that some provision proposed by the United States is unfavorable, or identifies a provision that might actually be unfavorable to its growth

Sept. 15, 2006, at C3 (announcing that the Interior Department was close to a settlement with several oil companies to prevent the loss of additional oil royalties).

66. See, e.g., *MTD Equity Sdn. Bhd. v. Republic of Chile*, Award, ¶¶ 114-115, 253, ICSID Case No. ARB/01/7 (May 25, 2004), 44 I.L.M. 91, 105-06, 129 (2005) [hereinafter *MTD Equity Sdn. Bhd.*, Award] (interpreting “fair and equitable treatment” to include a consistent and transparent relationship with a foreign investor).

67. Foreign investors use these asymmetries in bargaining power to obtain a better deal for themselves. They may know that particular interests within these countries are intent on reaching a trade agreement. A disadvantageous investment agreement is part of the price developing countries may feel they have to pay to obtain the desired trade agreement.

prospects, it has no chance of persuading the United States (or any other developed country) to change the standard agreement, especially if the provision touches on an important U.S. interest. Trade negotiators from several developing countries who have engaged in “negotiations” with the United States have repeatedly said, these are not negotiations in any meaningful sense. There can be some negotiations around the edges—whether the transition period will be two or three months or one year. But on any core issue, there is no flexibility. The United States will say, if we give you better terms, we will have to give them to everyone.⁶⁸

Fifthly, MNCs sometimes take advantage of their cross-border activities to insulate themselves from accountability. In old cowboy movies, the sheriff would chase the bandits to the state border—the bandit knew that once he crossed the border, he was safe. So too for the modern corporation. For example, the United States has refused, without explanation, to extradite the Union Carbide officials so that they could be held responsible for the mass loss of life at Bhopal, India.⁶⁹ Even when economic judgments are reached against a corporation in one jurisdiction, it may be difficult to enforce it in another. Smart MNCs know this and move assets out of jurisdictions where claims might be brought against them.

Finally, and perhaps most importantly, companies often act differently abroad than they do at home. This may be the result of differences in public sensitivities, especially differences in moral sensibilities to foreigners (rationalized with arguments like, “they are lucky to have a job”). Moreover, individuals are always more sensitive to peer pressure from those they view as their peers.

68. When it comes to discussions of provisions that seem particularly unfair, the USTR is also wont to say: We have no choice, our hands are tied, Congress simply will not allow us to pass a “fair” trade agreement. This is the best deal you can expect. Increasingly, though, some developing countries are responding: “We are a democracy too, and our government will not allow us to pass another unfair trade agreement; we will be voted out of office.” The spread of democracy may be inhibiting the number of agreements that are *known* to be unbalanced. That may be one of the reasons why many of the investment agreements are negotiated quietly, with little public discussion. See STIGLITZ & CHARLTON, *supra* note 5, at 74 (arguing that if citizens of democratic developing countries believe they are not receiving equitable treatment in trade negotiations, they will be less likely to reach an agreement).

69. *India Targets Elusive Carbide Figure*, L.A. TIMES, Feb. 9, 1989, at 2.

While developed countries have been adamant about developing countries opening up their economies to foreign investors, Western countries have not fully reciprocated. More recently, the United States has shown anxiety concerning China's purchase of a relatively small U.S. oil company, UNOCAL, much of whose assets lie outside the United States. The United States also expressed unease about the purchase of ports by a firm owned in Dubai.⁷⁰ Europeans were uneasy about the purchase of gas transmission companies by Gazprom, the Russian gas company.⁷¹ The Group of 7 ("G-7"), as an entity, expressed concern over the growth of sovereign funds, pools of money owned by foreign governments that are investing substantial amounts of money in their countries.⁷² Are these attempts to block foreign investors just another example of Western hypocrisy so evident in the sphere of trade? Are these anxieties reasonable? If so, they suggest a broader set of protections that home countries need to take against foreign investors than have typically been incorporated in the investment agreements foisted on developing countries. As we shall see at the end of the next section, the debate over sovereign funds helps highlight important limitations that should be imposed on investment agreements.

B. CONFLICTING DEMANDS FOR LEGAL FRAMEWORKS

The perceptions—and reality—that MNCs bring problems as well as benefits has put them in the center of enormous controversy. Demands for greater regulation have been met with demands for stronger protection. MNCs have put forth a list of desired demands in countries where they operate—for instance, low taxes and regulation, rights to move employees and capital in and out—but citizen groups have also put forth a list of demands of foreign companies that oper-

70. Steven R. Wiesman, *Brakes on a Foreign Deal*, N.Y. TIMES, Feb. 21, 2008, at C1.

71. See Judy Dempsey, *Europe Worries Over Russian Gas Giant's Influence*, N.Y. TIMES, Oct. 5, 2004, at W1 (expressing the particular concern that Russia's economic leverage is too large, given that around forty-four percent of Europe's gas comes from Russia).

72. See Robin Wigglesworth & Simon Kennedy, *Norway is Model for Managing Oil Riches*, INT'L HERALD TRIB., Oct. 18, 2007, at 11 (noting the concern of the G-7 that increased control by sovereign funds could lead to manipulation of markets).

ate within their boundaries—making contributions to national development efforts, acting in ways consistent with domestic laws and regulations, and the absence of special treatment. Worried about these demands, in recent years, MNCs have sought to achieve a greater degree of protection for their investments abroad through international treaties.⁷³

MNCs have, in addition, sought uniformity—but the uniform terms that they have sought are those that are favorable to their interests. The desire for greater protection of property and greater uniformity is understandable—uniformity may lead to lower costs, and greater protection may lead to lower risk premia. In a competitive world, both may result in lower prices and higher output.

The failed attempt at a MAI described earlier—and the many BITs that have been signed—can be seen as a response to these concerns. Before turning to an analysis of what is wrong with these agreements, we need to put the broad issue of corporate regulation in perspective.

III. ECONOMIC THEORY AND THE REGULATION OF INVESTMENT

A. FREE MARKET IDEOLOGY

Free market ideologies, which have provided what passes for intellectual foundations of much of the recent global economic legisla-

73. Of course, as a formal matter, it is the governments of the home countries of these MNCs that have sought and signed these agreements. However, trade ministries (in the United States, the USTR) typically represent the interests of the large MNCs; indeed, their lobbyists even accompany the USTR as it engages in negotiations, to ensure that the outcomes reflect *their* interests. In many cases, the position of the trade ministers may seem markedly out of sync with broader positions taken by the government. For instance, while a center piece of the Clinton administration was extending access to affordable health care, and while it was highly critical of the pharmaceutical companies, in its international negotiations, it was totally supportive of their position on intellectual property, which had the effect of reducing access to life saving medicines. When the consequences of this became public, it became a major source of embarrassment to the Administration. See STIGLITZ, *supra* note 1, at 105 (pointing out the incongruence between the Clinton administration's domestic and international agendas in regards to providing access to affordable drugs).

tion, would suggest that no global agreements are in fact needed. Countries, competing with each other, pursuing their own self-interest, would presumably arrive at a set of policies or regulations which are globally efficient. They would provide the optimal degree of property rights protection. If there are advantages to uniformity, standardization—around the right standards—would emerge on its own. The most that would be required is some mechanism for contract enforcement; but modern theories of reputation would suggest that even this may not be required. Countries that do not live up to their commitments lose their reputation and will be unable to recruit capital.

There is a curious—but hardly surprising—inconsistency on the part of the advocates of strong international economic agreements providing investor protections. They often seem to believe in free market ideologies, yet want strong government intervention in setting standards, including standards for property protection (as in the multilateral investment agreements). I say “hardly surprising” because when I served as Chairman of the CEA, I was continually beset by pleas from business interests for protection and subsidies: Everybody believed competition was good in general, but in their industry, they would complain about unfair or destructive competition; everybody believed that subsidies were bad—especially hand-outs for the poor—but that their industry needed help, often in the form of tax breaks or loan guarantees, for one of a myriad of reasons.

There is a second curious—but again hardly surprising—inconsistency on the part of the advocates of those who want strong “rights of establishment,” the rights of foreign companies to open up business in any country. This position is typically taken by those who believe that free markets and full competition is necessary (and almost sufficient) to attain economic efficiency. But in the perfect markets view, which underlies such presuppositions, ownership and control simply do not matter. Any owner would do exactly the same thing; indeed, it would make no difference whether the firms were controlled by workers, maximizing their wage income and subject to the constraint of being able to raise capital, or shareholders, maxi-

mizing their profit and subject to the constraint of being able to hire workers.⁷⁴

To be sure, few people on either side of these debates believe that to be the case; but that simply means that few people—including strong advocates of market-based solutions—believe in the assumptions that must be satisfied if markets, by themselves, are to yield efficient outcomes.

1. Central Ideas of Free-Market Economics Underpinning the Theory of Regulation

There are a few key ideas which underlie much of the current thinking about free-market economics, and much of the law and economics literature is predicated on these ideas:

Myth One: Adam Smith's Invisible Hand. Adam Smith's notion was that individuals and firms in the pursuit of their self-interest, guided only by competitively determined prices, lead the economy, as if by an invisible hand, to economic efficiency.⁷⁵ There is only limited need for government intervention—for example, in dealing with externalities.

Myth Two: Coasian Bargaining. But Ronald Coase suggested that even when there were externalities, one shouldn't worry: All we

74. See JOHN BATES CLARK, *THE DISTRIBUTION OF WEALTH: A THEORY OF WAGES, INTEREST AND PROFITS*, at v (MacMillan Co. 1927) (1899) (proposing that “the distribution of the income of society is controlled by a natural law, and that this law, if it worked without friction, would give to every agent of production the amount of wealth which that agent creates”). To be fair, many advocates of free market economics have in mind a different model of the market economy, one in which entrepreneurship plays a central role. See FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 278 (1921) (“It is unquestionable that the entrepreneur's activities effect an enormous saving to society, vastly increasing the efficiency of economic production.”). But while these ideas have been highly influential, modern economic analysis rests more heavily on the neoclassical analysis growing out of the work of John Bates Clark and Leon Walras.

75. See ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 423 (Random House, Inc. 1937) (1776) (asserting that by seeking the greatest value for themselves, entrepreneurs unwittingly further the interests of society at large).

need to do is assign clear property rights, and market participants will, through a process of bargaining, arrive at an efficient outcome.⁷⁶

There is a grain of truth in both of these ideas, but unfortunately, only a grain. Research over the past thirty years has shown that these propositions hold only under highly restrictive conditions—conditions not satisfied by any modern economy.⁷⁷ Economists had long recognized that markets are not efficient when there are externalities and public goods (though, as noted, Coase had suggested that even then government intervention was not required). But the major shift in the economic paradigm⁷⁸ resulting from the economics of information established that markets do not lead to efficient outcomes when information is imperfect (asymmetric) and when risk and capital markets are incomplete⁷⁹—that is always; more precisely, it can be shown that the market allocation is not, in general, constrained Pareto efficiency.⁸⁰ In short, there is no longer a presumption that

76. See Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 22-23 (1960) (asserting the role of property rights in resolving the problem of businesses causing harm to other businesses).

77. It was not until the 1950s, 175 years after Adam Smith's "conjecture" about the efficiency of competitive markets, that Kenneth Arrow and Gerard Debreu succeeded in establishing the conditions under which markets yield efficient outcomes. There are a host of "market failures," situations in which markets by themselves do not lead to Pareto efficiency, and in which appropriate government intervention can, in principle at least, make everyone better off. See Kenneth J. Arrow, *An Extension of the Basic Theorems of Classical Welfare Economics*, in PROCEEDINGS OF THE SECOND BERKELEY SYMPOSIUM ON MATHEMATICAL STATISTICS AND PROBABILITY 507, 507 (1951) (reviewing welfare economics under convex set theory); GERARD DEBREU, *THEORY OF VALUE: AN AXIOMATIC ANALYSIS OF ECONOMIC EQUILIBRIUM* 90 (1959) (defining the optimum economic state as "an attainable state such that . . . one cannot satisfy better the preferences of any consumer without satisfying less well those of another").

78. See Stiglitz, *Paradigm in Economics*, *supra* note 27, at 472-73 (challenging Adam Smith's theory that free markets lead to efficiency without the necessity of governmental participation).

79. The theory of imperfect information also helped explain why markets might be absent. See, e.g., George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488-500 (1970).

80. Bruce C. Greenwald & Joseph E. Stiglitz, *Externalities in Economics with Imperfect Information and Incomplete Markets*, 101 Q. J. ECON. 229-64 (1986); see also Richard Arnott et al., *Information and Economic Efficiency*, 6 INF. ECON. & POL., 77, 77-82 (1994) (providing a more detailed and diagrammed analysis focusing on the problems posed by moral hazard and insurance); Joseph E. Stiglitz, *The Invisible Hand and Modern Welfare Economics*, in INFORMATION, STRATEGY

markets, by themselves, will lead to efficient outcomes. Indeed, the presumption is the opposite.

When information is imperfect, markets are rife with externalities. For instance, if some individuals smoke more, it will drive up health insurance premiums. When insurance companies cannot observe whether individuals smoke or not, part of the costs of individuals who smoke is borne by non-smokers. There is an economic inefficiency, a market failure, which judicious government intervention (taxes on cigarettes or regulations) can help ameliorate.

Unfortunately, Coasian bargaining simply cannot deal with these market imperfections because of the underlying problem of lack of information: Non-smokers cannot tell who the smokers are and therefore cannot force them to compensate them for smoking. But even in simpler contexts of ordinary externalities, Coasian bargaining will not lead to Pareto efficiency so long as there are transactions costs and information asymmetries.⁸¹ The externalities associated with imperfect information (and incomplete markets) are so diffuse and pervasive that it is inconceivable that they could be addressed through Coasian bargaining; but the information imperfections themselves mean that the kind of compensation envisioned in Coasian bargaining—where, in a world with well-defined property rights,

AND PUBLIC POLICY 12-50 (David Vines & Andrew A. Stevenson eds., 1991) (providing a more accessible exposition).

Constrained Pareto Efficiency simply means that no one can be made better off without making some one else worse off, *taking into account the imperfections of information and the limitations in markets, and the cost of obtaining information and creating markets.*

81. Coase himself was aware of the importance of bargaining costs, but did not fully appreciate the inefficiencies to which it can give rise when there are transactions costs and information imperfections. The view developed within the profession of law and economics is that the presence of transaction costs implies that one should assign property rights in a way that minimizes them (the least cost avoider). Guido Calabresi, Comment, *Transaction Costs, Resource Allocation and Liability Rules*, 11 J.L. & ECON. 67, 73 (1968). But this either ignores the distributional consequences of such assignments or implies that they can be “undone” costlessly. See *infra* Part III.A.2. Moreover, it does not address the essential public policy issue: Given the potentially large bargaining costs, are there other public policy interventions that might lead to better outcomes? Simply assigning “well defined” property rights may not be the best way to approach the problem of externalities. See Joseph Farrell, *Information and the Coase Theorem*, 1 J. ECON. PERSP. 113, 125 (1987) (offering, as an alternative, institutional negotiation leading to a mutually beneficial and efficient outcome).

those imposing external costs on others compensate them for the damage they suffer—is impossible.⁸²

2. *Equity*

Of course, even if markets were efficient, efficiency is not everything: In particular, the market may result in a distribution of income that does not comport with any system of social justice, and accordingly, governments might want to intervene in the market allocation. But the “free market” school has an easy answer:

Myth Three: *The Neoclassical Dichotomy*. Issues of efficiency and equity can be separated. Governments can achieve any distribution of income they want—any Pareto efficient outcome—simply by redistributing initial endowments.⁸³ In designing regulation, governments should simply focus on efficiency.

But redistributions are costly. The modern information paradigm has explained why that is the case, and why the distribution of income itself may have consequences for efficiency. The implication of this, in turn, is that distributional objectives need to be considered in the design of regulatory regimes.⁸⁴

The important conclusion of this subsection is that giving greater security to *unfettered property rights* does not necessarily lead either to greater efficiency or higher levels of social welfare. If bilateral trade agreements are to be seen as part of a welfare enhancing agenda—and not just as a means by which rich and powerful countries

82. Sometimes, one can devise costly sorting mechanisms to identify the injured and the injurers, but the costs of running such a system may be high, markedly greater than those associated with an efficient regulatory system.

83. This is sometimes referred to as the “Second Fundamental Theorem of Welfare Economics.”

84. See Stiglitz, *Paradigm in Economics*, *supra* note 27, at 520-21 (arguing that economic policies are most efficient when those policies take into account the objectives and concerns of the population in a way more holistic than traditional economic theory has done). For instance, the nature of the agency problems in society depend on the distribution of wealth; if farmers own their own land, there is no need to resort to sharecropping or to monitor wage labor. Joseph E. Stiglitz, *Incentives and Risk Sharing in Sharecropping*, 41 REV. ECON. STUDIES 219, 251-52 (1974) [hereinafter Stiglitz, *Sharecropping*]. The argument parallels the analysis that shows that distributional concerns need to be taken into account in determining the optimal supply of public goods. See Lawrence J. Lau et al., *Efficiency in the Optimum Supply of Public Goods*, 46 ECONOMETRICA 269 (1978).

exploit weak developing countries—this perspective must be considered when interpreting the provisions of bilateral investment agreements.

B. THE NEED FOR INTERNATIONAL REGULATION

Even if there is a need for government regulation, it does not mean that there is a need for international regulation. Indeed, standard beliefs in the efficacy of competition among communities would argue the opposite.

Myth Four: *Tiebout Competition*. Communities competing against each other would make certain that the legal environment ensuring economic efficiency would be established. People would migrate to communities (countries) with strong property rights, and away from those without it.⁸⁵

In a sense, Tiebout's argument is more robust than that of Smith and Coase; in Tiebout's world, there might be imperfections in markets that necessitated government intervention, but each country would have an incentive to adopt the optimal regulatory system. Given the restrictive conditions under which market competition ensures economic efficiency within a country, it is not surprising that competition among communities does not generally result in global efficiency.⁸⁶

85. See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956) (arguing that competition among communities results in efficiency). Tiebout himself only focused on competition in the supply of public goods and taxation.

86. See Joseph E. Stiglitz, *The Theory of Local Public Goods*, in THE ECONOMICS OF PUBLIC SERVICES 274, 332 (Martin S. Feldstein & Robert P. Inman eds., 1977) (questioning Tiebout's argument and indicating that inefficiency can arise out of competition between communities because such competition is inevitably "imperfect"); Joseph E. Stiglitz, *The Theory of Local Public Goods Twenty-Five Years After Tiebout: A Perspective*, in LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS 17, 48 (George R. Zodrow ed., 1983) (reanalyzing the inadequacies in Tiebout's assertion that community competition leads to Pareto efficiency and arguing that the conclusion is valid only under highly restrictive conditions); Joseph E. Stiglitz, *Public Goods in Open Economies with Heterogeneous Individuals*, in LOCAL ANALYSIS OF PUBLIC FACILITIES 55, 72-74 (Jacques-François Thisse & Henry G. Zoller eds., 1983) (finding that under the implausible conditions under which the Tiebout conclusion was valid, each community would have only a single type of individual of any given skill, and there would be unanimity in all voting about local taxes and

It should be clear, however, that much of the demand for international regulation is not related to failures of Tiebout competition, and virtually none of the argumentation for such regulation is based on this analytic framework. Rather, the argument seems to be that the business community in the advanced industrial countries believes that developing countries have not provided as strong of property rights protection as they would like, and they use their political leverage to implement protections in developing countries that they have not been able to get themselves in their own countries.⁸⁷ In short, it is a distributive motive, though cloaked in an efficiency rationale: It is argued that it would be good for the developing countries.⁸⁸ But if strong property rights protections were beneficial for

expenditures). The fact that this describes no local community is evidence against the Tiebout hypothesis.

87. Using, of course, the argument that by providing such protection through a treaty, they will be able to attract more FDI. As we have seen, the evidence for such claims is weak, at best.

88. When I say “good” for developing countries, in the language of economics, this means a Pareto improvement, one which benefits all citizens, and which accordingly would be supported by all, regardless of the political process. There is an alternative interpretation: Good for developing countries could mean good on average or good for only some groups. Of course, if there were good redistributive mechanisms, good on average could be translated into good for all—the winners would compensate the losers. But in practice, losers know that such compensation is often not paid and therefore exert what political influence they can to stop such “reforms.” Similar reasoning holds for reforms that benefit some groups at the expense of others. Evaluating policies in terms of whether the winner *could* compensate the losers (whether they do or do not) is sometimes referred to as the Hicks-Kaldor criterion. See, e.g., Alan O. Sykes, *The Welfare Economics of Immigration Law: A Theoretical Survey With An Analysis of U.S. Policy*, in JUSTICE IN IMMIGRATION 158, 160 (Warren F. Schwartz ed., 1995) (referring to Hicks-Kaldor efficiency where a policy is superior when an individual who benefits from adopting it compensates an individual who is detrimented sufficiently so that he remains benefited). In fact, I would argue that investment agreements may actually fail under this weaker criterion. However, one of the problems of globalization is that it is systematically associated with increasing inequality. Certain groups dominate the political processes obtaining agreements that benefit themselves, often at the expense of the poor. The Hicks-Kaldor criterion simply ignores these distributive consequences. There is a third criterion—whether the policy (investment agreement) increases *social welfare* using an egalitarian social welfare function (of which the Rawlsian criterion is one example). See SAMUEL FREEMAN, JUSTICE AND THE SOCIAL CONTRACT: ESSAYS ON RAWLSIAN POLITICAL PHILOSOPHY 51 (2007) (describing Rawlsian political philosophy which argues that a policy is desirable only if it benefits the worst-off individual). In terms of this criterion, investment treaties are also likely to fail.

developing countries, presumably developed countries would have adopted such regulations on their own.

1. Why the Governments of a Developing Country Might Sign Agreements That Are Collectively Not in Their Interests

Developing countries are in competition for investment from the advanced industrial countries. Even if it could be shown that signing such an agreement led to more investment in a cross-section empirical study,⁸⁹ it does not mean that developing countries as a whole benefit. As in other areas of competition, there can be a race to the bottom. The Nash equilibrium entails each developing country sacrificing its own interests (for example, with lower environmental or worker protections) in hope that it will gain enough additional investment to more than offset the losses. But, of course, when they all do so, none gain. It is other factors which, in the end, determine which country benefits from the investment.⁹⁰

There is an equally bad possibility: there are differences among countries in their willingness to, for example, sacrifice the environment to get more investment. BITs may be part of a signaling equilibrium, by which developing countries indicate how much they are willing to sacrifice in order to get this additional investment. In general, such signaling equilibria are inefficient.⁹¹

2. Why Investment Agreements Might Collectively Be in the Interests of Developing Countries

There is one, more positive, argument for why a developing country might want to sign a BIT: Governments might want to forbid

89. See *supra* note 7 and accompanying text.

90. Of course, there may be some additional investment in developing countries as a whole, at the expense of developed countries. The other characteristics—wage advantages and infrastructure disadvantages—would seem to be of overwhelming importance, which partly explains the fact that these agreements do not seem to have had the desired effect. See V.N. BALASUBRAMANYAM, FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES: DETERMINANTS AND IMPACT (2001), available at <http://www.oecd.org/dataoecd/53/20/2407305.pdf> (listing factors foreign investors consider when deciding where to invest abroad). Not surprisingly, the existence of a treaty was not central.

91. See, e.g., Greenwald & Stiglitz, *supra* note 80 (arguing that signaling equilibria are, in general, constrained Pareto inefficient).

themselves from engaging in certain actions that might disadvantage investors, but they have difficulties in making credible commitments. International agreements, such as BITs, increase the cost of abrogating such promises, thereby making the commitment more credible. But if this (an example of what is sometimes called “public failure,” a limitation on governments that leads to potentially inefficient outcomes) were what motivated such agreements, presumably developing countries would be asking for such agreements; they would be perceived as mutually beneficial. In practice, they are part of the *demands* developed countries impose on developing countries, often as part of trade agreements, acceded to by developing countries because the cost to the developing country is less than the surplus they believe they will receive as a result of the trade deal.⁹²

C. CORPORATE GOVERNANCE AND BANKRUPTCY REGULATION

One of the arenas in which governments often impose regulations is corporate governance and bankruptcy. Again, market-based economics forces one to ask, why is there a need for such legislation? Can market participants not voluntarily make arrangements without government intervention? The role of the government is simply to enforce property rights—in this case, enforce contracts, so that private parties abide by their agreements. From this perspective, firms

92. Often developing countries are not fully cognizant of the costs of these provisions. It is not clear that they would have signed them had they been fully apprised of the consequences. Moreover, some developing countries willingly bind their hands by means of such agreements often in the mistaken belief that BITs will yield massive new flows of FDI. Indeed, as in the Indonesian example noted earlier, a country can provide investor guarantees with commercial arbitration, through legislation, not even part of an international agreement; but, of course, in these instances the legislation can be reversed far more easily. Sometimes, the government, in signing the agreements, may be reflecting business interests and ideology. As noted, domestic businesses can, by incorporating abroad, take advantage of these provisions intended to attract foreign firms.

The fact that there are South-South BITs implies that there are pressures other than those that MNCs impose driving these agreements. Egypt, for instance, has dozens of BITs with countries in Africa, Asia, Eastern Europe, and Latin America. *See* Official Website of the Eleventh Session of the U.N. Conference on Trade and Dev. [UNCTAD XI], www.unctadxi.org (last visited Feb. 6, 2008). Still, the fact that South-South BITs often “do not go as far as North-South BITs in terms of setting new policy standards and privileges for transnational corporations” is evidence of the effect of Northern bargaining power. *See* Official Website of Bilaterals.org, <http://www.bilaterals.org> (last visited May 14, 2008).

could raise capital under any agreement they wanted and with any corporate governance they desired; the firm's charter would spell out all the rights, both control rights and rights to income. For instance, the firm might borrow money from lenders, with a loan covenant that stipulated that if the borrowers could not repay the amount lent, the only assets that attached would be those of the corporation (just as in collateralized borrowing, the only asset that can be attached in the event of a default is the asset that has been put up as collateral).

Interestingly, this position has relatively few advocates; there is widespread support for the idea that governments should have laws regulating corporate governance and bankruptcy. But the laws that exist reflect two further myths:

Myth Five: Shareholder Value Maximization Leads to Economic Efficiency. Simplistic Marshallian economics⁹³ was based on the notion that firms maximize the well-being of their owners, but modern corporations have many owners, with different preferences. In this more complicated setting, the dictum is that firms should maximize stockholder value; policies which do so are desirable to all shareholders and will ensure economic efficiency.

Myth Six: Takeovers Ensure Shareholder Value Maximization. When worries were raised that managers' interests might deviate from that of shareholders, there was again an easy answer: Any firm that did not maximize its value would be taken over; the person taking over the firm would change the policy and reap the gain from converting to a value-maximizing strategy.

Myth Five provides the normative basis of legislation (common in the Anglo-American tradition) dictating that corporations should undertake actions which maximize shareholder value. Myth Six provides the basis of legislation restricting actions that might impede the takeover process, because it is the takeover process which provides the most important mechanism of ensuring shareholder value maximization. Myths Five and Six provide the basis of providing defer-

93. Alfred Marshall was one of the great economists of the last part of the nineteenth and early part of the twentieth centuries. At the turn of the century, he was asked to describe both the achievements of economics up to that point and the limitations. He specifically noted its failure to address the economics of modern corporations. Alfred Marshall, *The Old Generation of Economists and the New*, 11 Q. J. ECON. 115, 130-33 (1897).

ence to management: After all, any management team that did not maximize shareholder value would presumably be replaced rather quickly.

Interestingly, the conditions under which these conclusions are true—assumptions of perfect information and complete contracting—are conditions in which there is no need for government regulation (government would simply enforce contracts). The conditions that lead to a need for government regulation are the conditions under which shareholder value maximization is not in general welfare maximizing. Many governments outside the Anglo-American sphere argue for a broader stakeholder view: Companies should pay attention to the well-being of other stakeholders, including workers and the community (for example, the Rheine model, sometimes referred to as stakeholder capitalism⁹⁴). However, this view has been roundly criticized by advocates of shareholder maximization. Economic theory is, however, more supportive of the latter view.

Indeed, the very reason that corporate governance is an issue is related to imperfect information—shareholders have to delegate responsibility for decision-making to managers. With costless information, presumably shareholders themselves could “order” the managers to engage in activities that maximize their well-being, and with costless monitoring, ensure that they complied.

Even without imperfect information, so long as there is not a full set of state-contingent markets,⁹⁵ referred to as Arrow-Debreu securities markets, value maximization does not generally lead to Pareto efficiency.⁹⁶ Thus, the widespread view that firms should maximize shareholder value has no normative basis in economic theory.

94. See Will Hutton, *An Overview of Stakeholding, in* STAKEHOLDER CAPITALISM 3 (Gavin Kelly et al. eds., 1997), for an overview. See MASAHIKO AOKI, *TOWARD A COMPARATIVE INSTITUTIONAL ANALYSIS* (2001), for an alternative analytic framework comparing different forms of capitalism.

95. State contingent markets are markets for the delivery of particular goods at particular locations at particular dates in the event of particular contingencies (which fully describe the world) occurring.

96. See J. E. Stiglitz, *On the Optimality of the Stock Market Allocation of Investment*, 86 Q. J. ECON. 25, 45 (1972) [hereinafter Stiglitz, *Allocation of Investment*] (stating that while an economy with a complete set of Arrow-Debreu securities markets may be Pareto efficient, in the real world, where there is an incomplete set of such securities, the conclusion is not valid); Joseph E. Stiglitz, *The Inefficiency of the Stock Market Equilibrium*, 49 REV. ECON. STUDIES 241, 257

When a complete set of futures markets does not exist, it may even be difficult to determine what a long-run value maximizing market strategy might look like—different individuals may differ in their judgments about the prices that are likely to prevail in the future or on the probabilities of different states.⁹⁷ There will not be a general consensus on what is required to maximize today's stock market value. But even if there were, that will not generally lead to a constrained Pareto efficient outcome.⁹⁸

Moreover, shareholders will not, in general, all agree that the firm should maximize *today's* shareholder value. Many shareholders may be interested in the long-run value of the firm, and may argue that the markets are simply "uninformed." These shareholders will argue for taking actions that the market thinks are "wrong," even if it decreases the value of shares today. This is especially true of those shareholders who plan to hold the company's shares for a long time: Why should they worry about whether the company meets its quarterly earnings estimate?

Disagreements about what is in the interests of shareholders arise frequently, and courts often give deference to managers.⁹⁹ But managers' interests often diverge from that of shareholders or other stakeholders. Indeed, Adolf Berle and Gardiner Means emphasized

(1982) (finding that where there are two or more outputs, the allocation of resources by a stock market is not a constrained Pareto efficient outcome as argued by Diamond in the case of an economy with only one output).

97. See Stiglitz, *Bankruptcies and Take-Overs*, *supra* note 39, at 712-14, for an early exposition of the ensuing problems.

98. See Sanford J. Grossman & Joseph E. Stiglitz, *Stockholder Unanimity in Making Production and Financial Decisions*, 94 Q. J. ECON. 543 (1980) (finding that shareholders would be unanimous in favoring a particular course of action only under highly restrictive and unreasonable conditions); S. J. Grossman & J. E. Stiglitz, *On Value Maximization and Alternative Objectives of the Firm*, 32 J. FIN. 389, 399-400 (1977) (arguing further that, in general, shareholders will not want the firm to maximize shareholder value).

99. See, e.g., *Zupnick v. Goizueta*, 698 A.2d 384, 387 (Del. Ch. 1997) (describing the high burden of proof shareholder plaintiffs must bear in order to successfully sue the managers of a corporation); Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organizations: The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179, 179-82 (2001) (finding that courts grant deference to managers over shareholders as a result of the business judgment rule, justified by the complex nature of business decisions, the need to "encourage entrepreneurial risk," and the assumption that managers will take risks in order to maximize returns).

the separation between ownership and control in their classic work.¹⁰⁰ My own work provided theoretical foundations for this division—imperfections of information and costs of information necessitated delegating decision-making (from owners to managers), but it is impossible to align perfectly the interests of managers with shareholders.¹⁰¹ Understanding the roots of the separation between ownership and control is necessary, in turn, for designing an appropriate legal framework for corporate governance.

Highlighting the disparity of interests are the actions managers deliberately undertake to enhance asymmetries of information between themselves and shareholders—and other potential buyers—and otherwise to entrench themselves. These actions may enable management to extract a larger share of the firm's value, even if they simultaneously decrease the firm's market value.¹⁰² They impede the efficacy of the takeover mechanism. But even without these distortions, the takeover mechanism may not ensure that the firm will engage in value maximizing strategies—the only instances where takeovers may be easy are those where shareholders believe that a raider will destroy the value of the firm.¹⁰³

100. See BERLE & MEANS, *supra* note 37, at 112-16 (asserting that the modern corporation changed the traditional premise of ownership and control by producing two new groups, each with divergent interests: “owners without appreciable control and the control without appreciable ownership”).

101. This concept has come to be called the Principal-Agent problem. See Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134 (1973) (analyzing the problem of agency and its relationship to principals in terms of economic equilibrium). See Stiglitz, *Sharecropping*, *supra* note 84, for an early analysis of the Principal Agent problem. While the setting of the problem was that of the landlord trying to ensure that his tenant farmer maximized the return he received, I pointed out that the problem was essentially that of the owners of the firm trying to ensure that the manager acted in ways consonant with their interests. *Id.* at 247, 252 n.1.

102. See Edlin & Stiglitz, *supra* note 39, at 1308-09 (exploring the opportunistic behavior of managers when they enhance their income and position in the firm by creating information asymmetries).

103. It is interesting that in spite of the importance (at least in theory) of the takeover mechanism, particularly in ensuring discipline for managers, there was little formal literature in this area until my 1972 paper on takeovers. Stiglitz, *Bankruptcies and Take-Overs*, *supra* note 39. There is by now literature empirically proving that the takeover mechanism does not work well. See DAVID J. RAVENSCRAFT & F. M. SCHERER, *MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY* 204-10 (1987) (suggesting that even if the acquired firm benefits, takeovers often lead to a decrease in the value of the acquiring firm); Anup

More generally, *the management of a public company is a public good*,¹⁰⁴ and consequently, there will be systematic market failure. All shareholders benefit if other shareholders monitor management in ways that lead to increased returns. The same is true for all creditors, with one critical difference: Because of the lower level of risk, there may be less risk diversification. A single lender may have such a sufficiently large stake that it pays him to monitor the firm closely. Shareholders benefit to the extent that by avoiding excessively risky activities, or activities that benefit the manager at the expense of the corporation as a whole, the probability of bankruptcy is reduced. But to the extent that creditors focus on minimizing the risk of default, the overall expected returns of the firm—and hence of equity owners—may be reduced.

While it is often difficult to test whether firms are maximizing their shareholder value, there are many instances of corporate behavior that seem hard to reconcile with such a view. *Ex post* it is easy to make judgments: A firm that invests \$100 billion—and winds up with a market capitalization of \$20 billion—clearly did not use shareholder money well. But perhaps, given the information that was available or which could reasonably have been obtained, it might have been *ex ante* the right decision. It is difficult for outsiders to judge the *ex ante* information (including all the relevant probabilities). However, there are a large number of instances where outsiders can make judgments—we can ascertain whether firms maximize shareholder value with respect to the management of their tax liabilities. The fact is that both corporate financial policies and employee compensation programs are designed such that billions of dollars are paid unnecessarily in taxes; there are simple changes that would have

Agrawal et al., *The Post-Merger Performance of Acquiring Firms: A Re-Examination of an Anomaly*, 47 J. FIN. 1605, 1618 (1992) (finding that on average in a merger the stockholders of an acquiring firm will lose ten percent of their stock wealth in the five years after the merger is complete). There are a number of reasons for the failure of the takeover mechanism. Grossman and Hart point out that if a small shareholder believes that the takeover will be successful and will increase the value of the firm, it would not pay him to sell, but to “free ride” on the successes, sharing in the capital gains. Only if he believes that the takeover will decrease the value of the firm—and will be successfully completed—will he be easily induced to sell his shares. Grossman & Hart, *supra* note 39, at 45.

104. That is, all shareholders benefit if the firm's profits increase. *See supra* note 48 and accompanying text.

no real consequences other than the tax liabilities. These are called tax paradoxes, and they strongly support the view that firms often do not maximize shareholder value.¹⁰⁵

In contrast to the standard paradigm that views managers faithfully carrying out the mandate of maximizing shareholder value—with any manager who does not comply, either out of incompetence or because he has his own agenda, being quickly replaced—a more accurate paradigm sees manager-controlled enterprises, maximizing their own welfare, subject to a set of constraints and oversights. These manager-controlled enterprises operate in such a way as to expand their range of control and their market power vis-à-vis those who might take them over by, for example, creating asymmetries of information.¹⁰⁶ These constraints are such as to effectively create an imperfect hierarchy of “control.” Banks provide the most direct set of controls, most closely monitoring the regular activities of the firm. Shareholder discontent must be kept low enough that there is not a battle of control, either from dissident shareholders or from takeover

105. The earliest of these is called the dividend paradox. See Joseph E. Stiglitz, *Taxation, Corporate Financial Policy, and the Cost of Capital*, 2 J. PUB. ECON. 1 (1973). Since I wrote my paper, a much larger fraction of the revenue of corporations is distributed to households in a tax preferred way. While tax paradoxes are the most obvious deviation from shareholder value maximization, there are others: many closed end mutual funds sell for a market value less than the value of their shares. There is a simple action—dissolving the firm—that would lead to an increase in shareholder value. Since this paradox was first discussed in the 1970s, the magnitude of the discount in closed end mutual funds in some parts of the world has actually increased, and a number of funds have been created to take over these mutual funds and to realize shareholder potential. The difficulties that they have encountered illustrate the problems of corporate governance and takeover mechanisms more generally. Other paradoxes relate to forms of compensation. There are forms of compensation which provide good incentives, with less total (corporate plus individual) taxes and better risk-sharing properties than those commonly employed by firms. See JOSEPH STIGLITZ, *THE ROARING NINETIES: A NEW HISTORY OF THE WORLD'S MOST PROSPEROUS DECADE* (2003) [hereinafter STIGLITZ, *THE ROARING NINETIES*]. Other paradoxes related to inventory accounting include the choice between FIFO and LIFO and the use of accelerated depreciation. See Joseph E. Stiglitz, *The Design of Labor Contracts: The Economics of Incentives and Risk Sharing*, in *INCENTIVES, COOPERATION AND RISK SHARING* 47 (Haig R. Nalbantian ed., 1987) (suggesting three criteria—risk-sharing, incentives, and flexibility—on which the effects of compensation and employment policies should be evaluated); Stiglitz, *Paradoxes*, *supra* note 39, at 317-18.

106. See Edlin & Stiglitz, *supra* note 39, at 1302 (arguing that managers make investment decisions that enhance their income and job security).

agents. Securities markets enter periodically, in assessing firm performance when additional capital is required—though the potential need for such additional capital exerts a more continuing influence on firm behavior.¹⁰⁷

1. Bankruptcy Law

Corporate governance laws provide rights and responsibilities for various parties engaged in decision-making by on-going corporations. Corporate bankruptcy laws are an important part of corporate governance laws. They define what happens when corporations cannot meet their debt obligations. They specify rights to claims on different assets, as well as control rights (rights to decision-making) like who gets to propose an alternative organization involving the disposition of certain assets, and who must give their approval. For instance, typically creditors take control of the firm in the event of bankruptcy.¹⁰⁸ Corporate governance laws have important implications for decision-making *before* bankruptcy; in particular, they are partly responsible for why creditors may often have more influence in decision-making than holders of equity.¹⁰⁹

In a world of perfect contracting, there might seem to be no need for bankruptcy laws, just as there would presumably be no need for corporate governance laws more generally. All governments would need to do is enforce the contracts which would specify what would happen if the party fails to fulfill the contract. In fact, however, gov-

107. Firms prefer to raise more of their capital long-term, rather than to be kept on a short leash by banks. There are certain efficiency gains from doing so, namely insulating firms from the risk of volatility in short-term capital markets. But the monitoring benefits associated with short-term (bank) credit are such as to lead to the optimal contract being shorter-term than the investment projects they finance. Patrick Rey & Joseph E. Stiglitz, *Short-Term Contracts as a Monitoring Device* (Nat'l Bureau of Econ. Research, Working Paper No. 4514, 1993).

108. See *Corporate Bankruptcy*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 483, 483-84 (Peter Newman ed., 1998) (providing an overview of the rules and procedures for corporate bankruptcy in the United States, including the different procedures that creditors may follow to recover part of their investment and the role of the court, creditors, and managers play in a bankruptcy procedure).

109. See Stiglitz, *Credit Markets*, *supra* note 38, at 146, 150 (stating that because banks can withdraw funds or decline to renew a corporate loan, they are in a better position to exert influence over managers than are shareholders).

ernments do far more than just enforce contracts. Developing countries have been encouraged to adopt robust bankruptcy laws. Some of the problems many of the East Asian countries faced in the midst of the 1997 crisis were blamed on inadequate bankruptcy laws; the IMF and the U.S. Treasury did not chastise the banks for having signed loan contracts that did not adequately specify what happened if the borrowers could not meet their obligations.¹¹⁰

There are, however, good reasons for governments to impose bankruptcy laws, good reasons that they do not simply leave the determination of what happens when borrowers cannot meet their debt obligations to contractual terms. Why this is so is a question to which we turn in the next subsection.

2. Meaning of Ownership and Control

Ownership matters for two reasons: rights to control (make decisions) and rights to income.

Ownership defines residual rights to control. It is actually very difficult to specify fully what one might mean by “control rights.” Governments, at all levels, have some control rights, in the sense that they restrict the kinds of actions that firms can undertake, and they can affect those actions more broadly through tax policy and incentives. Banks can insist that a firm take certain actions, if they are to extend or not withdraw credit—the firm may have little choice but to accept these conditions, especially if it has debt obligations that could force it into bankruptcy. I use the term “residual control rights” to reflect that, given all of these other constraints, there may still be

110. See Steven Radelet & Jeffrey D. Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, BROOKINGS PAPERS ON ECON. ACTIVITY 42, 70 (1998) (noting that investor criticism of weak bankruptcy laws in East Asian countries encouraged the creditor panic that exacerbated the East Asian crisis resulting in reformed bankruptcy laws and a safety net for creditors); see also Joseph Stiglitz & Jason Furman, *Economic Crises: Evidence and Insight from East Asia*, BROOKINGS PAPER ON ECONOMIC ACTIVITY 2 (1998) (discussing the various factors contributing to the crisis, including those cited by the IMF and the US Treasury).

some scope of choice, and presumably the “owner” has the right to make a choice among this set.¹¹¹

In the simple neoclassical paradigm, workers and the suppliers of other factors have a horizontal supply curve at the competitive market price, so that the actions of the firm have no effect on them. Each firm is a “price taker,” that is, so small that nothing it does can affect prices, wages, or interest rates. The actions of the firm only affect the residual returns, what the firm has for itself, after paying for all factors of production that it uses. Thus, the controller of residual rights, in exercising those rights, only affects his own well-being, and that is why allowing him to do so freely naturally results in economic efficiency.

But in the real world, that is not the case. There are many stakeholders who are affected by the firm’s actions. That this is so can be said to reflect a “market failure,” but it is worthwhile digging deeper to ask, more specifically, why this is the case. Part of the reason is that there is incomplete contracting and incomplete insurance. A worker who goes to work for a firm does not know fully the jobs that will be assigned to him, how difficult or unpleasant the tasks will be, or the hours that he might have to work. The firm might not know either. There are contingencies that cannot be perfectly anticipated. But different actions by the firm can affect the likelihood of more or less pleasant contingencies occurring—and, therefore, can affect the well-being of the worker. They might, for instance, increase the likelihood that he will be redundant. The worker may have invested in (firm-specific) human capital, but there is no insurance against the destruction of the value of that capital should he be fired.

Bondholders are aware that the firm may take actions that adversely affect their claims to the firm, and typically that is why there are bond covenants. But it is well-recognized that these covenants only constrain a fraction of the possible actions that the firm might take.

In short, actions of firms—including subsequent contracts with third parties—affect the well-being of those who have previously

111. Moreover, the bank may provide a set of conditions that the firm must satisfy if the bank is to roll over its loans; the firm always has the right to reject those conditions, even if it means the firm would be forced into bankruptcy.

signed (implicit or explicit) contracts.¹¹² Different governments may take different positions on how these externalities might best be dealt with—for example, through voice on the boards of directors or restrictions on the kinds of contractual arrangements that can be undertaken. To date, economic theory has not provided a simple set of prescriptions that define how to best handle these externalities in all situations.

As an example, some governments require bonds to include collective action clauses, which allow a qualified majority (say eighty-five percent of the bondholders) to restructure. It is recognized that there may be circumstances in which renegotiation is desirable, but that in such circumstances, a small minority can hold up what might otherwise be a Pareto superior renegotiation, demanding a ransom. On the other hand, the ability of a (qualified) majority to restructure a debt contract means that they can, in principle, redesign the contract in ways that work markedly to the disadvantage of the minority: The minority may not simply be holding up the majority but may have legitimate differences in interests and perspectives. Regrettably, it is difficult to write a simple legal framework that protects against one abuse without opening up the window to another.

There is another set of “externalities” that may arise, which relate to signaling. Bankruptcy provisions may be used to signal one’s likelihood of going bankrupt. Firms that have a low probability of going bankrupt may signal that that is the case by imposing heavy penalties

112. Those who believe that markets solve all problems also believe that competition in contract terms (for example, degree of flexibility or severance pay) should lead to efficiency in contract terms. Arrow and Debreu showed that this simplistic reasoning was wrong, and that competitive markets led to efficiency only under a set of highly restrictive conditions. *See* DEBREU, *supra* note 77; Arrow, *supra* note 77, at 510 (focusing on competitive equilibria in which there are prices and markets for all goods, at all dates, in all states of nature, and under all contingencies). This assumption was obviously not satisfied in the real world. Subsequent research attempted to model the nature of competitive equilibria, in which market participants compete over contract terms. *See, e.g.,* Stiglitz, *Sharecropping*, *supra* note 84. The problems arise because contracts themselves are incomplete, for reasons which will be discussed at greater length below. As noted, Greenwald and Stiglitz essentially showed that whenever information is imperfect or markets are incomplete, the competitive contract equilibrium is *not* Pareto efficient. *See* Greenwald & Stiglitz, *supra* note 80, at 230 (finding that when markets are incomplete or information imperfect, competitive markets do not lead to (constrained) Pareto efficiency).

on themselves should they go bankrupt.¹¹³ But it is easy to see that the resulting signaling equilibrium is not Pareto efficient. Signals are costly, and in general, signaling equilibria are inefficient. Governments may enforce a better equilibrium by eliminating the scope for signaling, for example, by imposing a standardized bankruptcy regime.¹¹⁴

Finally, it is impossible—prohibitively costly—to have contracts that anticipate every contingency. All contracts are incomplete, and it is the important role of government to specify what happens in those unanticipated contingencies—a set of “defaults” that greatly simplify contract drafting.¹¹⁵

In addition to these externalities, there are a host of more widely discussed macroeconomic externalities, where decisions by firms have social costs that they do not appropriately take into account (just as firms do not take into account environmental externalities). For instance, even without unemployment insurance benefits, firm decisions concerning layoffs do not lead to Pareto efficiency;¹¹⁶ with

113. Analogous to those imposed by the most creditor-friendly bankruptcy laws.

114. In technical terms, this is referred to as imposing a pooling equilibrium. Competitive market equilibrium cannot be characterized by pooling. See Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q. J. ECON. 629, 637 (1976). The inefficiencies in contractual equilibria are, however, not limited to problems of signaling. In moral hazard models, contracts by one party affect reservation levels and behavior within other contracts. See Richard J. Arnott & Joseph E. Stiglitz, *Labor Turnover, Wage Structures, and Moral Hazard: The Inefficiency of Competitive Markets*, 3 J. LAB. ECON. 456-58 (1985) [hereinafter Arnott & Stiglitz, *Labor Turnover*] (examining the effect that contracts between an employer and a potential employee can have on the behavior of other employees and firms throughout the market).

115. See Joseph E. Stiglitz, *Contract Theory and Macroeconomic Fluctuations*, in CONTRACT ECONOMICS 292, 308 (Lars Werin & Hans Wijkander eds., 1992) (commenting that courts are comfortable filling in the gaps of standard contracts, but will sometimes punish parties that attempt to contract for all contingencies). Asymmetric information can also explain why the economy may get stuck in inefficient contractual equilibria. The problem is that if a standard emerges—and there are good reasons why that might be the case—then any attempt to deviate from that standard may be interpreted as a signal. Moreover, if a party believes that the party proposing the change is more informed, he may infer that the reason the party wants the change is to obtain a larger share of the value (rather than, as he is likely to argue, to increase the efficiency of the contract). *Id.* at 306-07.

116. This is most obvious in efficiency wage models, where wages affect productivity either because of effects on incentives, selection, morale, or labor turn-

unemployment benefits in unemployment systems that are not fully experience-rated, it is obvious that when firms lay off an individual, it imposes a social cost on others.¹¹⁷

D. IMPLICATIONS FOR THE ROLE OF GOVERNMENT

The implications of these views for corporate governance laws are clear and strong: First, the presumption in many jurisdictions of deference to management ought to be rethought. Management has both the ability and incentive to pursue their own interests, which may conflict with those of other stakeholders, including shareholders. There are enough instances of abuse of discretion—and a clear enough theoretical basis suggesting that management’s interests may conflict with other stakeholders—that one should presume that managers act in their own interests.

For instance, in my book, *The Roaring Nineties*, I explained how unfettered markets, or more accurately, markets with poorly designed

over. For instance, in the Shapiro-Stiglitz “shirking” model, firms must pay a high enough wage to induce individuals not to shirk on the job. The requisite wage depends on the unemployment rate and the rate of time that individuals remain in the unemployment pool. Firms that have a policy of letting go of labor more easily lead to higher labor turnover, and, at any unemployment rate, a shorter duration in the unemployment pool. This means that the equilibrium unemployment rate will be higher. More generally, it is optimal to slow this process down, for example, with mandatory severance pay. See Arnott & Stiglitz, *Labor Turnover*, *supra* note 114, at 455-57 (analyzing the effect imperfect information has in a worker's decision on whether to stay at a particular job or move on to another); Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74 AM. ECON. REV. 433, 433 (1984) (finding that firms will choose to pay higher than the “going wage” to induce employees not to shirk); Joseph E. Stiglitz, *Alternative Theories of Wage Determination and Unemployment in LDC's: The Labor Turnover Model*, 88 Q. J. ECON. 194, 210 (1974) (applying wage increases as a method of labor retention and higher productivity to least developed countries contributing to the disparity between urban and rural wages); Joseph E. Stiglitz, *Alternative Theories of Wage Determination and Unemployment: The Efficiency Wage Model*, in THE THEORY AND EXPERIENCE OF ECONOMIC DEVELOPMENT 78, 78, 86-87 (Mark Gersovitz et al., 1982); Joseph E. Stiglitz, *Prices and Queues as Screening Devices in Competitive Markets*, in ECONOMIC ANALYSIS OF MARKETS AND GAMES 128, 142 (Partha Dasgupta et al. eds., 1992) (finding that employers are willing to pay a high wage in order to get a higher quality labor force).

117. The East Asia crisis called attention to macroeconomic externalities arising from excessive borrowing, especially in foreign currency. The size of some of the recent claims made through BITs is sufficiently large that they could, in fact, have macroeconomic externalities.

regulatory and tax regimes, led to perverse incentives, whereby executives had incentives to disclose misleading and incomplete information and information in forms that were not easily analyzed by the market.¹¹⁸ Bad information led to poor resource allocations. But the system did allow some people (including the chief executive officers (“CEO”) of some companies) to do very well.

It is understandable that courts would want to defer to the “business judgment” of managers. *Ex post*, decisions often turn out wrong, and courts are seldom called upon to question management when they go right. “Monday morning quarterbacking” provides ample opportunity for raising questions about motives when decisions appear flawed. Yet, current practice often gives management an easy pass; they can pursue their own interests, cloaked in language suggesting that it is, in their judgment, in the best interests of the firm or shareholders.

There is thus a case that can be made for a change in presumption. Management should continue to be placed in the position of a fiduciary, one entrusted to make certain risk decisions. The problem is not that the courts fail to recognize this fiduciary obligation; but rather, as noted, they give excessive deference to management’s judgments, not putting sufficient weight on the potential conflicts of interests between *their* interests and those of other stakeholders.¹¹⁹

Courts can be asked to make judgments about whether a reasonable person, given the information that managers had, or reasonably could have obtained at the time, adequately balanced the risks and rewards facing other stakeholders, and when management failed to do so, whether the balance of risks and rewards facing management was such as to likely distort its decision.¹²⁰

118. See STIGLITZ, THE ROARING NINETIES, *supra* note 105, at 243-50 (discussing the case of Enron and how it “benefited from the perverse incentives provided by banking deregulation”).

119. See *Federal Deposit Insurance Corp. v. Stahl*, 89 F.3d 1510, 1516-17 (11th Cir. 1996) (finding that honest errors and actions conducted in good faith will not expose directors to liability); see also *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989) (explaining that the business judgment presumption attaches to all decisions made by directors and must be rebutted by the introduction of evidence of self interest).

120. See, e.g., *Abramowitz v. Posner*, 672 F.2d 1025, 1031 (2d Cir. 1982) (employing a two-step analysis to explore the motives of a corporation when challenged by a shareholder).

Second, there is a strong rationale for corporate governance laws that give a voice to other stakeholders affected by managerial decisions in ways not fully reflected in the price system, so that there are meaningful and real externalities.¹²¹ Some increases in job security might, for instance, lead to Pareto improving investments in human capital by workers or reductions in unemployment; even if these changes are not Pareto improving, they could improve the well-being of workers.¹²²

A critical aspect of corporate governance legislation is bankruptcy law. The specification of what happens when a firm cannot meet its debt obligations cannot, and should not, be left simply to the private partners themselves to specify in the contracts.

E. DIFFERENCES AMONG COUNTRIES

As we look across countries, we see marked differences in laws governing corporate governance and bankruptcy, and the kinds of contracts commonly found. There are three possibilities:

- a) Each is efficient, but there are different circumstances in different countries; the differences reflect the distinctive circumstances of the country.
- b) There are multiple equilibria, one of which Pareto dominates the other; some countries are “stuck” in an inefficient equilibrium.¹²³ There is an important role for government to ensure that the Pareto superior equilibrium is chosen.

121. Adam Winkler, *Corporate Law of the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 *LAW & CONTEMP. PROBS.* 109, 119-20 (2004) (describing the view that “employees, consumers, or the larger public” are constituents of, and thus require a voice in, corporate decisions).

122. In models of perfect competition, there are no asymmetries of bargaining power because no one has bargaining power. However, in reality, there are. Legislation protecting workers’ rights reflects a concern for these asymmetries in bargaining powers. Asymmetries in globalization have led to greater liberalization for capital (so capital can move more freely) exacerbating these imbalances.

123. Recall the point repeatedly made: Market equilibria may or may not be efficient. When there are multiple equilibria, none, some, or all of them may be efficient, with some groups better off in one equilibrium compared to another.

- c) There are multiple equilibria; all the observed equilibria could be Pareto efficient with different distributional consequences.

IV. IMPLICATIONS FOR BILATERAL INVESTMENT AGREEMENTS: THE DANGERS OF STANDARDIZATION

All three interpretations provide a strong cautionary note against the current wave of BITs. The first case suggests that standardization would have a cost—in reducing efficiency within at least one of the two countries—and since it is more likely that the standard that will be accepted will be that of the developed countries, the brunt of the loss is more likely to be born by the developing country.¹²⁴

The second interpretation provides compelling evidence against the market fundamentalist perspective that has provided the intellectual foundations for these agreements, that all that is required for economic efficiency is for the government to enforce property rights.¹²⁵

In the third interpretation, there are likely to be large distributional consequences within countries. It may be difficult to compensate for the changes in distribution that result from standardization; even if it is possible, there may be large (deadweight) losses associated with such compensation.

124. The market fundamentalist view would have it that if there is a competitive equilibrium contract which specifies, for example, compulsory arbitration through commercial courts, it must be efficient. But we have already explained why contract equilibria, even in competitive markets, are not Pareto efficient. *See supra* notes 112 and accompanying text. Investment agreements are not contracts between two private parties, but two public bodies, and even if it were the case that competitively determined contract equilibria were Pareto efficient, it does not mean that these agreements lead to Pareto efficiency.

125. I have referred to the kind of inefficiency exhibited by Pareto dominated multiple equilibria as a “structural inefficiency,” as opposed to the case where there is just a marginal distortion, like too much or too little investments. Indeed, given the value of say all other investments, it might not be possible to improve the equilibrium by altering the levels of a particular investment. But when all decisions are changed, in a coordinated way, a Pareto improvement can be achieved. *See Stiglitz, Allocation of Investment, supra* note 96, at 52. Of course, even when there are not these structural inefficiencies, there are a myriad of marginal inefficiencies where government interventions could lead to Pareto improvements.

For instance, the design of bankruptcy laws is hotly contested. The United States has recently adopted a bankruptcy law which is decidedly pro-creditor.¹²⁶ Other countries should have the right to decide, for instance, whether to have a more pro-debtor bankruptcy law. The point of this discussion is not so much to advocate reform of the laws on corporate governance or bankruptcy (though the analysis should make it clear that at least many of the arguments put forward for some legal structures do not have solid economic foundations), as to argue that (a) in general, there is more than one set of rules and regulations consistent with Pareto-efficiency; (b) different rules and regulations may have distributive consequences (that is, some rules may lead to one group being better off, others worse off), and accordingly, one cannot see legal frameworks as simply ensuring economic efficiency; and (c) competition among communities is sufficiently limited so that countries do have choices among alternatives and is sufficiently imperfect in that it does not necessarily result in efficient outcomes.

Issues of efficiency and equity are inextricably linked—and indeed, there is a long legal tradition that views the rule of law as protecting individuals from what might emerge in unfettered markets.¹²⁷ Any restriction on the choice a country makes with respect to these laws may thus be welfare reducing.

126. See generally Bruce C. Scalambrino, *Bankruptcy Reform for Non-Bankruptcy Lawyers*, 93 ILL. B.J. 518 (2005) (discussing pro-creditor reform in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 including changes in preferences, fraudulent transfer powers, venue provisions, reclamation claims, and protections for warehousemen).

127. As noted earlier, one of the central criticisms of the Chicago School of Law and Economics is that it focuses on efficiency.

V. IMPLICATIONS FOR BILATERAL TRADE AGREEMENTS: RIGHTS OF ESTABLISHMENT

This is important because rights of establishment¹²⁸—rights of corporations from abroad to enter a country—are different from rights concerning movements of labor or capital. When labor moves into a country, it knows that in doing so, it must respect the laws of the country. When capital moves in, it knows that in doing so, it must respect the laws of the country. But corporations are neither people nor capital, but legal entities with particular governance structures. Of course, when companies enter a country they must obey laws relating to the treatment of the environment or workers. But governments care about corporate governance because they believe that the well-being of their citizens may depend on how these legal fictions, corporations, behave, and in particular, how they are governed. Countries have granted these legal fictions limited liability;¹²⁹ but in doing so, they have every right to impose restrictions on how these entities are governed. Those governance structures affect the functioning of the economy, including the rights and well-being of various groups. Allowing foreign corporations to produce within a country allows entities governed by different laws to engage in business

128. Under many BITs, investors from party states enjoy the right to establish or invest on a national-treatment basis. For instance, if a U.S.-Ukraine BIT exists, the Ukraine could not let local businesspersons own and operate a retail supermarket while banning U.S. nationals from doing so. However, these treaties often exclude certain sectors. For example, the United States does not give a right to establishment on the national-treatment basis in certain sensitive sectors such as airlines and broadcasting. Strikingly, many developing countries have not shown the same degree of foresight when it comes to excluding delicate sectors. Indeed, the United States often exploits developing countries' limited scope for identifying such sectors by insisting on a *negative* list—entry should be allowed in all sectors *except* those identified—rather than a positive list which would enable the country to focus on some sectors where it believes foreign entry would be advantageous or at least not seriously disadvantageous. There is opposition to a trade or investment treaty with the United States in several countries because they doubt their capacity to identify every sector where an exception would be necessary to protect against U.S. investment and ownership. (Recent agreements focus more on rights of establishment; older agreements often did not. Therefore, it is likely that the majority of agreements in existence today do not include such provisions.)

129. See Greenwald & Stiglitz, *supra* note 35, at 49-52 (discussing the importance of limited liability for the functioning of capitalism).

in ways and according to rules which its own citizens, operating within the country, cannot enjoy.

Worse still, with free mobility of capital, those within the country can choose to establish corporations abroad, and then enter the country operating under a different set of rules than those which the country deemed best for itself. For instance, many investors use Dutch holding companies or intermediary companies so that they can enjoy the protections of the Netherlands' unusually extensive system of investment treaties.¹³⁰ By going off-shore to incorporate a foreign subsidiary, then investing in their own country, they get the protection of a treaty—not given to small businesses that can ill afford these circumventions of domestic law—and they detour around their own courts, and can gain access, when they believe it favors them, to international arbitration.¹³¹

In short, unfettered rights of establishment, combined with free mobility, vitiate the ability of countries to establish rules governing corporate governance and bankruptcy. If there were a single set of efficient rules, then this would make little difference: All countries could agree on the desirable set of rules, and that would be the end of the matter. But we have argued that these rules do matter, and that there is no single set of Pareto efficient rules. To see how it makes a

130. One of the often cited examples is *Aguas del Tunari, S.A. v. Bolivia*. Bechtel, the U.S. parent company of Aguas del Tunari, S.A., established a post office in the Netherlands, so that the International Centre for Settlement of Investment Disputes ("ICSID") could have jurisdiction. See SARAH ANDERSON & SARA GRUSKY, CHALLENGING CORPORATE INVESTOR RULE 18 (Inst. for Pol'y Studies & Food & Water Watch 2007). More telling, two of the three arbitrators at ICSID seemingly were enthusiastic about Bechtel's strategy describing BITs as "portals" through which investors from a multitude of countries might choose to make onward investments into the developing world, and thereby enjoy the treaty protections. See IISD, *Tribunal Split in Bechtel-Bolivia Case Over Corporate Nationality of Investor*, INV. TREATY NEWS (Dec. 20, 2006), http://www.iisd.org/pdf/2005/itn_dec20_2005.pdf (summarizing the tribunal's two-to-one ruling dismissing all of Bolivia's jurisdictional objections).

131. In one controversial ICSID ruling, a tribunal split two to one on the question of whether this particular type of treaty-shopping is legitimate. See IISD, *ICSID Tribunal Splits Sharply Over Question of Corporate Nationality*, INV. L. & POL'Y WKLY. NEWS BULLETIN (June 11, 2004), http://www.iisd.org/pdf/2004/investment_investsd_june11_2004.pdf (describing the majority's decision that investors may incorporate in another country in order to adopt the nationality of that state). When treaty obligations undermine national policies, they can have seriously adverse policies for a country. See discussion on South Africa *infra* Part IX.

difference, consider what happens if a firm goes bankrupt. The priority of claims under a treaty may be different from that which would have prevailed under domestic law.

Free international commerce can easily be reconciled with restrictions on the rights of establishment. Firms entering a country would simply be required to establish subsidiaries inside the country. The subsidiaries would be governed by the laws within the country. Capital (“ownership”) moves freely, but the rights of the owners (relative to those of others) and their obligations would be governed by the laws of the host country.

If the view conveyed in the previous section is taken, then all corporations operating within a country would be domestic corporations, and all that would be required is that corporations within the country all be treated the same—there would be no discrimination against a corporation (or any business for that matter) as a result of ownership. The problem is that the bilateral agreements go well beyond this.

“Rights to establishment” involve one aspect of a broader set of issues—*who is protected by the investment agreements*. An issue that has drawn some attention is whether an “investor” is any foreigner doing business in the country: After all, *some* investment is always required to engage in business. By most accounts, the intent of the investment agreements was to facilitate foreign direct investment (“FDI”), not foreign firms simply entering the country to sell their products. This more expansive interpretation would be of little consequence if firms could only be compensated for losses of actual investment expenditures, but it could saddle countries with huge liabilities if compensation had to be provided for lost business opportunities. As noted later, some decisions have included compensation for lost profits.¹³²

Equally disturbing are protections proposed in some recent investment agreements (and investment provisions in bilateral trade agreements) to *potential* investors “pre-establishment”: Firms might

132. These were among the disturbing aspects of *S.D. Myers, Inc. v. Canada* discussed at greater length below. See *S.D. Myers, Inc. v. Canada*, Second Partial Award, ¶ 222 (NAFTA/UNCITRAL, Oct. 21, 2002) [hereinafter *S.D. Myers, Inc.*, Second Partial Award] (including the value of the lost and delayed net income streams in the measurement of damages for adverse effects on investment).

have to be compensated for potential losses in profits for an establishment that they *might have made or that they were contemplating making*, in the event of a change in regulations, which, for example, makes such investment less attractive. The magnitude of claims that might arise under such provisions (and the speculative nature of the losses)—at least in the case of an expansive interpretation that included lost potential profits—is enormous.¹³³

A. EXCEPTIONS

As noted, most bilateral trade agreements require non-discrimination, often referred to as national-treatment. But most countries carve out exceptions, especially in areas of foreign ownership (rights to establishment). The United States insists U.S. citizens own the airlines and TV and radio stations.¹³⁴ In addition, shipping between U.S. ports must be done using U.S. ships, manned by U.S. citizens.¹³⁵ More recently, the United States has raised concerns about a Chinese firm buying a small American oil company, or a Dubai firm buying some American ports. Various Group of Eight members have raised concerns about sovereign funds buying assets in their countries (wealth managed by governments; as many governments in the developing world have amassed trillions of dollars of reserves, they have sought to manage these funds in ways that yield higher returns, moving out of T-bills into equities). To many, especially in the developing world, such attempts at restricting foreign ownership raise the specter of double standards and hypocrisy. If there are problems that ownership raises, why could they not be dealt with effectively by regulation?¹³⁶ If ownership matters, might private

133. Again, neither the U.S. government, nor any other government to my knowledge, has ever provided these kinds of protections to domestic investors.

134. See 49 U.S.C. § 40102(a)(15)(C) (2000) (including in its definition of a U.S. citizen “a corporation . . . organized under the laws of the United States . . . , of which the president and at least two-thirds of the board of directors and other managing officers are [U.S.] citizens . . . , and in which at least seventy-five percent of the voting interest is owned or controlled by persons who are citizens of the United States”).

135. See Merchant Marine Act, 46 U.S.C.A. § 50101(a) (West 2007) (declaring the necessity of a domestically owned and operated merchant marine for national defense and growth of foreign and domestic commerce).

136. I have argued elsewhere that there are some sectors where ownership may matter—but then, one should be worried about private ownership, whether foreign

domestic owners “misbehave” just as foreign owners would? In these instances, there is a problem of misalignment of public and private incentives. If the United States and Germany believe that foreigners should not have a controlling interest in certain sectors, why cannot developing countries have similar views? Who should determine the lists?

The advanced industrial countries, with well-established economies and well-defined interest groups, are in a better position to understand the importance of such exceptions and to develop a comprehensive list that reflects their interests and concerns.

Standard infant industry and infant economy arguments provide a strong rationale for why the protection of particular industries, including the financial sector, may be desirable as part of a developmental strategy. But the very fact that such countries are not developed means that there may not be any interest groups to demand the requisite exception. As a result, whole ideas and sectors may be foreclosed from domestic development, and the limited set of instruments at the disposal of poor countries for advancing their development is further circumscribed. That is why there is a compelling case for a positive list approach, where developing countries identify the sectors where foreign investors should be allowed in, until they can be sure that there are not adverse effects in the other sectors yet to be adequately investigated.

It is important to emphasize, however, that the various problems with BITs will not be solved merely by requiring foreigners to incorporate local subsidiaries in the host state or by establishing negative or positive lists. Local incorporation will be necessary, but not sufficient, to address some of the problems discussed here. Rather, as we shall see, there is a need to restructure the treaties as well.

We turn now to some of the key provisions of these agreements.

or domestic. For instance, a private firm owning a plant which makes atomic bombs might have an incentive to sell it to the highest bidder. Economic incentives could be sufficiently great as to overcome regulator proscriptions. JOSEPH E. STIGLITZ, *GLOBALIZATION AND ITS DISCONTENTS* 177 (2002).

VI. WHAT RECEIVES PROTECTION? REGULATORY TAKINGS

A major concern with investment agreements is that they go well beyond simply protecting against explicit expropriation. Indeed, the risk of expropriation can easily be insured through the Multilateral Investment Guarantee Agency of the World Bank Group and insurance provided by many of the advanced industrial countries, like the Overseas Private Investment Corporation in the United States. The problem giving rise to investor protections is that every country can take actions that decrease the value of an asset—so much so that they are tantamount to expropriation. For example, an individual has beachfront property on which he plans to build a house. The government decides that there is a public good in ensuring that the beachfront remains pristine, and therefore decides that no house can be built upon it. However, it leaves the individual as the owner; he can prevent others from trespassing on his property. But his use of the property is so circumscribed that the value of the land has been greatly diminished. Is this tantamount to expropriation?

These are difficult issues which most governments have had to address at one time or another. The United States has come out strongly: Compensation generally is not required.¹³⁷ The most famous set of cases involves the Endangered Species Act of 1973 (“ESA”), which requires the conservation of property when its alteration would adversely affect an endangered species.¹³⁸ Forests in Oregon could not be cut down while the endangered red-cockaded woodpecker and the threatened northern spotted owl nested there.¹³⁹ Those owning the forests did not receive compensation, despite the fact that the main value of the forest was for logging.¹⁴⁰

137. *See, e.g.*, *Babbitt v. Sweet Home Chapter of Communities for a Great Oregon*, 515 U.S. 687, 707 (1995) (deferring to the broadly construed definition of “harm” under the ESA to hold the reasonable interpretations of takings as environmental violations).

138. *See id.* at 708 (finding in favor of the Secretary of the Interior’s interpretation of the word “harm” “to include ‘significant habitat modification or degradation where it actually kills or injures wildlife’”).

139. *Id.* at 692, 708.

140. *Id.* at 696, 708.

Whether these decisions are right or wrong is not of concern:¹⁴¹ The issue is that they have given governments broad discretion in taking actions that decrease, almost entirely, the value of an asset, without requiring compensation. At least one recent decision under BITs seems to have overturned this fundamental principle without, as argued below, either legislative approval or effective domestic judicial review.¹⁴² There is no evidence that in signing these bilateral trade agreements, for instance, the United States had abandoned this principle; certainly, the Administration, in proposing the agreements, did not suggest that there was a fundamental alteration in legal principles, and Congress, in passing it, did not have a discussion that would have constituted a legislative endorsement of such a fundamental shift in legal principles.

The most noxious provisions of bilateral trade agreements—and the most obvious intrusion in the rights of a country to self-

141. There is an important distinction, I believe, between regulatory takings, discussed below, and the ESA, in which private parties are asked to provide a public good, namely the preservation of a species. Interestingly, Coase's analysis of property rights would suggest that there is in fact little difference; what is required is only certainty of property rights. It is only the change in property rights associated with the passage of the law that is of concern. Coase, *supra* note 76, at 10-11. With the law now on the books for more than three decades, to change it again (for example, to compensate owners when a spotted owl alights on their property) would represent the kind of "uncertainty" to the property rights regime that should be criticized; the change would represent an undeserved windfall to the owners of the assets.

142. See *Metalclad Corp. v. Mexico*, Award, ¶ 112, ICSID Case No. ARB(AF)/97/1 (Aug. 30, 2000), 40 I.L.M. 36, 51 (concluding that Mexico violated NAFTA by "indirectly expropriating Metalclad's investment" when it prevented Metalclad from operating its landfill). Since *Metalclad Corp.*, foreign investors have latched onto the "precedent" arguing that regulatory takings should be compensable under BITs. By and large, however, tribunals have declined to find states liable for expropriation, except where there has been some substantial deprivation—not just a new regulation or tax that imposes a few million dollars more in costs on a hundred-million dollar project.

In contrast, in *Methanex*, the presiding tribunal, in a 2005 final ruling, came out quite strongly in favor of the United States which had to defend measures undertaken by California. See *Methanex Corp.*, 44 I.L.M. at 1460. As in other aspects of these agreements, uncertainty remains. This does not bode well for governments looking to exercise their core regulatory, corporate governance, and social justice functions. The fact that arbitration panels have not provided a string of pro-investor rulings in these expropriation cases may not be as comforting as it may seem: They have found other grounds, such as "fair and equitable treatment," to rule in favor of investors.

governance—concern regulatory takings. The provisions require compensation to foreign businesses for regulations that decrease the value of an asset (of an ongoing business, or, in some cases, a potential business).¹⁴³ All countries pass a myriad of regulations to improve economic efficiency and to affect the distribution of income. While such regulations may not always be based on sound economic theory or evidence, and may be designed and implemented in ways that do not fully achieve their objectives, or which, in achieving their objectives, may encounter significant adverse ancillary costs, every country has the right to adopt such regulations and to do so without compensating those adversely affected.

There are sound theoretical reasons why they should have the right to do so. The underlying justification for such regulations is that without them, the economy is often not Pareto efficient, and even if it is Pareto efficient, the distribution of income that emerges in the market may not be consistent with any principles of social justice. Environmental regulations have played a central role in reducing air and water pollution, to the benefit of the vast majority of citizens. Affirmative action legislation in many countries, regulating employment practices, is viewed as essential in undoing the consequences of long-standing discrimination against certain groups in society.

The underlying justification for *restrictions* on the ability of governments to impose regulations is that without such restrictions, returns on investments will be exposed to political risks—such as the risk of a change in regulations, and the exposure to such risks will reduce the level of investment and lower standards of living. The argument against imposing such restrictions on the freedom of sovereigns to impose regulations is that it restricts their ability to adapt to changing circumstances and preferences. This is especially important in democracies, and even more important as societies change from imperfect democracies controlled by small elites to more contestable democracies.¹⁴⁴ In such cases, the elites can pass legislation empow-

143. Sometimes, the provisions extend to taxes, and for good reason. It is often possible to achieve any regulatory outcome through the imposition of an appropriate set of taxes.

144. There is a view, which is receiving increasing support, that countries should be able to repudiate debts incurred by earlier non-democratic governments when the funds did not benefit society. These debts are called *odious debts*. STIGLITZ, *supra* note 1, at 228-31. By the same token, we can think of *odious trea-*

ering themselves, even when these regulations result in economic inefficiencies. Restrictions on changes in taxation and regulation serve to make it more difficult to change the distribution of wealth and power in society. Moreover, as countries develop, new societal problems emerge, requiring new regulations. Regulating nuclear power plants may not be necessary before a country reaches a stage of development where it has such a plant, and only with the development of the plant can it learn fully what kinds of restrictions might be required to mitigate what are perceived as certain external effects. The investor may not have fully disclosed all the externalities, and governments should have the ability to respond as these problems become evident. More generally, requiring compensation for changes in societal regulations makes it more difficult to restore social justice and to correct market inefficiencies because such changes are made more expensive.

Domestic courts have repeatedly faced the challenge of balancing the costs and benefits of such restrictions and have drawn a distinction between explicit expropriations, where compensation is required, and other instances of possible diminution in asset values.¹⁴⁵ Indeed, when applied to the area of taxation, the demand for compensation yields the absurd result that governments could never increase taxes; for if the value of the asset is its expected present discounted value of future income, any increase in taxes would have to be fully offset by a compensatory payment.¹⁴⁶

The adoption of regulatory provisions within BITs applicable to foreign corporations when countries have themselves rejected such

ties, in which illegitimate governments incur obligations which do not inure to the benefit of the majority of the citizens of the country. Subsequently, democratically elected governments should, in this view, be freed from honoring obligations imposed by odious treaties.

145. See, e.g., *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1015-16 (1992) (distinguishing between regulatory takings for which an affected individual receives compensation for damages or losses incurred).

146. Fortunately, in the handful of cases that have emerged to date on taxation-as-expropriation, it appears that the threshold is high—requiring a confiscatory tax with very heavy repercussions. See *EnCana Corp. v. Ecuador*, Award, 45 I.L.M. 901, 935 (2006) (holding that Ecuador had not breached the provisions of the BIT with Encana for failing to refund value-added taxes). The point I am emphasizing is that the principle that there be compensation for value lost, as a result of changes in government policy of any form, would be dangerous.

regulatory taking provisions completely eviscerates the country's normal political processes and policies. Any domestic firm could establish a foreign subsidiary, and the foreign subsidiary could then undertake business in the country—with all the protections afforded by the BIT. It is only small businesses and individuals, unable to pay the legal and other transactions costs, which are then left unprotected.

A. THE COASE OBJECTION

There is one objection to this argument that was discussed briefly in Part III: Efficiency simply requires the clear assignment of property rights (the Coase theorem), and BITs do that. BITs give property rights to investors, a result that may have distributional consequences, but if society objects to these, it should simply engage in offsetting redistributions.

We have already explained the fallacies in the underlying arguments—the Coase theorem is *not* correct when there are transaction costs, imperfect information, and costly redistributions. That may be part of the reason that most countries have adopted the *Polluter-Pays Principle*: Rights to clean air and water are owned collectively, and those who destroy these must pay a price.¹⁴⁷ The bilateral trade agreements threaten to reverse this presumption, and may have done so without the kind of democratic debate that should have been employed for such a fundamental change in property rights. Indeed, there is a strong feeling that reversing this presumption was the intent of the bilateral investment agreements: to undertake an end run around normal democratic institutions, to get in secret trade negotiations, or, in fast track processes designed to limit legislative oversight in the adoption of trade legislation, what they could never have succeeded in getting in a more open, transparent, and democratic, “normal” domestic legislative process.

To repeat, a Coasian might say: So what? Yes, we have changed property rights. We have assigned the rights to the air to the polluting

147. OECD, Recommendation of the Council on the Implementation of the Polluter-Pays Principle (1974), *available at* <http://webdomino1.oecd.org/horizontal/oecdacts.nsf/Display/C4D6B3E4F6BE9051C1257297004F86DA?OpenDocument> (reaffirming the Polluter-Pays Principle as fundamental for allocating costs of pollution prevention and control measures).

firm. But we have achieved economic efficiency. If there are enough citizens who do not like pollution, then they can simply pay the new owner of the property not to pollute. Either way, we get efficiency. But even if we put aside the difficulty of ascertaining which of the millions of citizens who might be adversely affected are actually adversely affected enough to want to compensate the polluter, this argument fails on two accounts. First, by giving the right to pollute to a foreign firm, we have taken away wealth from the citizens of the country; they are worse off, potentially by a significant amount. It is hard to see how a country would willingly give such an asset away. Second, there is no limit to the number of potential non-polluters. Every foreign firm could threaten to come in and pollute, and would then have to be compensated. The property right is assigned not to a particular firm, but, in any effect, to any firm that might contemplate coming.

Finally, undoing the distributional consequences of this kind of re-assignment of property rights is costly, and in some cases, impossible. Unless one can make a convincing case that citizens of the country *wanted* to transfer wealth to foreigners, presumably the reason that they would agree to such a provision is that, somehow, they believe that they will be made better off; that is, that a sufficient fraction of the profits generated can be captured by government and distributed to those who are worse off. But, where individuals are hurt so much by, say, the firm's pollution that they induce the firm to shut down, there are no profits to be taxed. There is no way that what has been given to the foreigners can be recaptured.

B. STANDARDS

Many of the bilateral investment agreements look not just at the change in value from a government action, but also at the surrounding circumstances. Was the party treated "fairly and equitably," in a non-discriminatory manner? Was the policy forced by necessity? Each of these terms has a high degree of ambiguity, and there is a resulting uncertainty regarding their implications. Matters are made worse by the fact that arbitration panels have themselves not agreed on what these terms mean.

One might have thought that the least ambiguous term would be "tantamount to expropriation." But even this has been subject to var-

ied interpretation. In *Metalclad Corp.*, the Tribunal found that Mexico's decision to deny the use of its assets for the disposal of hazardous wastes was tantamount to expropriation.¹⁴⁸ But in doing so, it focused on *procedural* issues, such as transparency. The appellate judge rejected this claim because the tribunal had relied on a transparency obligation which, it contended, was not imposed as part of NAFTA.¹⁴⁹

Besides the concept of "expropriation," perhaps the least ambiguous is the term "non-discrimination"; but even here, all relevant factors are seldom the same.¹⁵⁰ What factors should be taken into account? A particular egregious case involved the transport of toxic wastes across the U.S.-Canadian border, a practice restricted by the Basel Convention.¹⁵¹ The Tribunal declared that Canadian law consistent with the Basel Convention discriminated against the U.S. firm because it could not deliver toxic waste to its waste disposal site in the United States.¹⁵² But it should have been clear: The discrimination was not based on ownership. Had a Canadian firm owned the site, and owned a business in the U.S. to acquire toxic wastes there, it

148. *Metalclad Corp.*, ¶ 112, 40 I.L.M. at 51.

149. In another case, *Methanex*, the Tribunal enquired into the *process* by which the decisions were made (like questioning whether the governor was influenced by political concerns) to determine whether the outcomes were "fair and equitable," but ultimately ruled against Methanex. *Methanex Corp.*, 44 I.L.M. at 1433.

150. One of the problems is that tribunals often seem to look both at discriminatory *effect* and at *intent*: Was the action intended to discriminate against the particular firm, even if similar actions could have been undertaken and justified, for example, on environmental grounds? The difficulty is that in political processes, different actors may have different objectives. Some may see economic advantages in acting discriminatorily, but others may be motivated by genuine worries about the environment. Parsing out the *real* motive is an impossible task, not one for which commercial tribunals are well-equipped to consider. The discriminatory effect can arise from regulations *intended* to protect the environment. For instance, in the area of trade, countries impose heavy taxes and regulations on large cars to reduce both pollution and congestion. The effect of such taxes and regulations is to discriminate against large, polluting U.S. cars. It may be the intent of some in the domestic automobile industry to discriminate; but there is a compelling social rationale for such taxes and regulations, even in the absence of any domestic automobile industry.

151. Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal, Mar. 22, 1989, 1673 U.N.T.S. 126.

152. See *S.D. Myers, Inc. v. Canada*, Partial Award, ¶ 322, 40 I.L.M. 1408, 1436 (NAFTA/UNCITRAL, Nov. 12, 2000) [hereinafter *S.D. Myers, Inc.*, Partial Award].

too would not have been allowed to ship material across the border.¹⁵³ Again, the question is not whether the Basel Convention on shipping hazard wastes across borders is good or bad policy; the question is whether a bilateral trade agreement should be allowed to override such agreements.¹⁵⁴

By the same token, there are provisions of law which appear to be non-discriminatory in design but are discriminatory in effect. For instance, the Community Reinvestment Act requires all banks to invest a certain fraction of their assets in underserved minority communities.¹⁵⁵ Some foreign banks have claimed that such restrictions are discriminatory in effect because their cost of compliance is greater. They are less informed, and they often specialize in banking niches (such as lending to MNCs) that would imply that compliance would necessitate major deviations from their business model. Yet it is clear that the provision was not adopted to discriminate against foreign firms, and allowing foreign firms an exception would eviscerate the effect of the legislation.

While the United States has supported the application of such provisions to foreign banks, it has objected to the imposition of analogous requirements by foreign governments—for example, that all banks wishing to have more than one branch must put a fraction of their branches in underserved areas.

The “fair and equitable” standard raises the question of “fair and equitable” to whom? It appears that at least some findings have taken a very narrow definition of the term, meaning fair to the investor, not judging fairness in the context of all of the other societal stakeholders. Indeed, this standard of fairness is tantamount to requiring

153. As always, there is ambiguity in the interpretation of the findings. The Tribunal, in its ruling, was quite clear in its finding that the relevant Canadian Minister had made various public statements suggesting that the government’s intention was, in fact, a protectionist one. *Id.* ¶ 194, 40 I.L.M at 1428. Still, even if this particular government minister was motivated to protect Canadian interests, had a Canadian firm tried to ship hazardous wastes across the border, others with jurisdiction might have successfully taken action, in compliance with the Basel Convention. This is especially true if there was a threat of sanctions, which the United States has occasionally discussed for those contemplating violating the Convention.

154. Technically, bilateral trade agreements do not override treaty obligations; they only mean that compensation must be paid.

155. Community Reinvestment Act of 1977, 12 U.S.C. § 2901(b) (2000).

compensation for any decrease in market value, as reasoned as it may be. It is certainly understandable how one might conclude that it is unfair that simply because a spotted owl has alighted on one's tree, that one can no longer engage in logging, leading to a decrease in property value. But it would perhaps be better to say that nature was unfair and that the investor was unlucky; certainly, though, if he purchased the property in the last thirty years, he knew that this was a risk.

By the same token, any purchaser of real estate in a city knows that he is subject to zoning restrictions, *and that these restrictions can change*. No country that I know of provides compensation for such changes in land usage restrictions. Yet, some BIT decisions seem to imply that that is the case.¹⁵⁶

The same principle applies, of course, to all regulations and legislation: As argued, no government can make itself subject to compen-

156. See *Metalclad Corp.*, ¶¶ 109, 131, 40 I.L.M. at 51, 54 (awarding compensation to Metalclad in the amount of its investment based on a finding that Mexico indirectly expropriated land when it created an ecological preserve containing Metalclad's landfill site). *Metalclad* addressed the processes by which the restrictions were imposed—the creation of a nature preserve established in the final days of the governor's term of office—and the nature of the assurances that the site could be used for the disposal of hazardous wastes. *Id.* ¶¶ 85, 104, 40 I.L.M. at 48, 50. Any firm working in a federal system should know that an official at one level of government cannot provide assurances about the law or other levels of government. Moreover, we have argued that governments should have the right to take actions in the interests of their citizens, including creating conservancy areas. In all democracies, a wide range of actions are taken in the final days of an elected government in the hopes that such actions will not be easily reversed. Those within a conservancy area are typically not compensated for any loss of value that results, nor do they have to compensate the government for any resulting increase in value. The presumption should be that the government was acting in the interests of its citizens in undertaking this action. Any complaint that the government exceeded its authority by acting in an arbitrary or capricious way should be addressed in domestic courts or through domestic political processes.

Especially in federal systems, foreign investors should know that one level of government cannot provide blanket assurances about what actions another level might undertake—yet many foreign investors seem to insist that they do so, and sue when such assurances fail. Without subverting the entire federal system, the best that a higher level authority can do is use the influence it has. *But see MTD Equity Sdn. Bhd.*, Award, *supra* note 66, ¶ 166, 44 I.L.M. at 115 (holding Chile liable for BIT breaches because that country's foreign investment review agency had approved an investment, which later could not obtain local land-rezoning permissions).

sation for the decreases in value occurring as a result of such changes.

Some have suggested that so long as the *process* by which such changes occur is open and transparent, compensation should not be required,¹⁵⁷ but claims for compensation have been made on the basis that the processes have not conformed to such high standards.¹⁵⁸ It has proven easier for investors to make a claim for lack of “fair and equitable treatment” than for breach of the expropriation standard. Particularly disturbing is that, in some of these cases, tribunals have interpreted “fair and equitable treatment” to entail extraordinarily high (I would suggest unreasonable) levels of obligations for developing countries to provide transparent, competent, responsive, and efficient administrative procedures.¹⁵⁹ Investors knew, or should have known, about the nature of the country’s administrative procedures. It was part of the “cost of doing business” that they should have

157. See, e.g., William Michael Treanor, *The Original Understanding of the Takings Clause and the Political Process*, 95 COLUM. L. REV. 782 (1995) (exploring the history and meaning of the Takings Clause of the Fifth Amendment of the U.S. Constitution and its purpose to guard against a failure in process). See generally Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA’s Investment Protections and the Misguided Quest for an International “Regulatory Takings” Doctrine*, 78 N.Y.U. L. REV. 30, 101-05 (2003) (presenting the fairness arguments based on process, which some theorize is more manageable and realistic than the high standards set by international tribunals).

158. See *MTD Equity Sdn. Bhd.*, Award, *supra* note 66, ¶¶ 134-135, 44 I.L.M. at 109-10 (summarizing the arguments of the claimants citing a lack of simple and transparent laws and regulations in Chile, which contributed to their unfair treatment).

159. See *Técnicas Medioambientales TECMED S.A. v. Mexico*, Award, ¶ 154, ICSID Case No. ARB(AF)/00/2 (May 29, 2003), 43 I.L.M. 133, 173-74 (2004) [hereinafter *TECMED*] (requiring that a country anticipate the expectations of investors in the interest of “fair and equitable treatment”). The expectations of investors broadly include consistency, transparency, and predictability in rules, regulations, administrative processes, and any other directives. *Id.* If a country fails to provide for any one of these expectations, it may be in breach of the obligation to provide “fair and equitable treatment,” as occurred in this case where the government responded to strong protests and local government changes by not renewing the license of a Spanish landfill operator. *Id.* ¶ 164, 44 I.L.M. at 177; see also *MTD Equity Sdn. Bhd. v. Republic of Chile*, Decision on Annulment, ¶¶ 65-71, ICSID Case No. ARB/01/7 (Mar. 21, 2007) [hereinafter *MTD Equity Sdn. Bhd.*, Decision on Annulment] (rejecting Chile’s request for an annulment of a prior award based on the argument that the Tribunal applied dictum from *TECMED* and in doing so set an unreasonably high standard for a host state’s obligations to foreign investors).

taken into account; and, indeed, the high returns that investors receive is, in part, compensation for the costs and risks of inadequate administrative procedures. Of course, I strongly support the development of such processes. That is not the issue. The question is, whether it should give rise to a claim for compensation.

One question is should there be a separate process for enforcing such procedures to protect foreign firms not available to domestic firms? Such discrimination would itself seem inconsistent with “fair and equitable treatment” for domestic firms and standards of due process.¹⁶⁰

There is something ironic about arbitration panels criticizing the administrative processes in developing countries. As I comment in Part IX, arbitration processes which are badly flawed (often neither open nor transparent) are not the best places for determining what processes should be viewed as acceptable.

Of course, there is another school of thought that would read the “fair and equitable treatment” obligation more modestly and in a manner which takes into account the level of development and capacities of the host state. As always, however, the unpredictability of the current mode of dispute settlement means that the parties (and the wider public) cannot be sure how a given tribunal will interpret this treaty provision in a given case.

A particularly contested provision is associated with the circumstances and manner in which contractual obligations can be breached, as exemplified by Argentina’s breach of its utility contracts in the midst of its 2002 crisis.¹⁶¹ There is an understanding that countries, in the face of some catastrophic event, may have to breach an agreement out of “necessity”—*force majeure*.¹⁶² Several tribunals

160. See *MTD Equity Sdn. Bhd.*, Decision on Annulment, *supra* note 159, ¶¶ 65-68 (explaining that the Tribunal did not exceed its powers in its stringent interpretation of fair and equitable treatment despite Chile’s claim that the Tribunal relied on extreme language).

161. See Thomas Catan & Mark Mulligan, *New Economic Strategy: Argentina Poised for Devaluation of the Peso*, FIN. TIMES (London), Jan. 6, 2006, at 8 (evaluating Argentina’s response to its failing economy, and quoting officials emphasizing that the move to freeze rates did not have protectionist aims, but rather was an attempt get the country to its feet again).

162. See Int’l Law Comm’n, Draft Articles on the Responsibility of States for Internationally Wrongful Acts, art. 23, *Report of the ILC on the Work of its Fifty-*

to date have found Argentina liable for breaching contractual provisions because Argentina violated the “fair and equitable treatment” promise contained in BITs.¹⁶³ However, tribunals have disagreed sharply as to whether such actions were “necessary” in the context of the financial crisis.¹⁶⁴ In *LG&E Energy Corp.*, the necessity defense had the effect of letting Argentina off the hook for financial compensation.¹⁶⁵ There was no requirement that the necessary actions be shown to have been done “fairly and equitably.”¹⁶⁶

Some argue further that to claim the defense of necessity, a country should not be responsible for the calamity that brought about the breach. Underlying such a contention is a standard moral hazard argument: If a country could breach a contract in the event of unbridled inflation, it might have an incentive to print money recklessly, creating the disaster which necessitates the breach.¹⁶⁷ What is clear in the

third Session, UN GAOR, 56th Sess., Supp. No. 10, at 43, UN Doc A/56/10 (2001) (establishing that a state can permissibly violate an international obligation in the case of an “irresistible force or . . . an unforeseen event, beyond the control of the State,” provided that the State does not invoke the force or event and has not assumed the risk). See *infra* Part VIII for a more thorough discussion of these issues.

163. See Arif Hyder Ali & Alexandre de Gramont, *ICSID Arbitration in the Americas*, in *THE ARBITRATION REVIEW OF THE AMERICAS 2008*, GLOBAL ARB. REV. (SPECIAL REPORT) 8 (2008) (reviewing ICSID arbitrations in the Americas, and specifically citing *LG&E Energy Corp.* and *Azurix Corp. v. Argentina*).

164. Compare *LG&E Energy Corp.*, ¶ 266, 46 I.L.M. at 73 (holding that the Argentine financial crisis amounted to a state of necessity, which exempted the state from liability for that specific period of time), with *CMS Gas Transmission Co.*, Award, *supra* note 10, ¶ 331, 44 I.L.M. at 1241 (holding that the Argentine financial crisis did *not* amount to a state of necessity, eighteen months after *LG&E Energy Corp.*).

165. See *LG&E Energy Corp.*, ¶¶ 266-267, 46 I.L.M. at 73-74 (finding that Argentina was exempt from responsibility during the state of necessity, but that it failed to reinstate the tariff regime after the state of necessity ended, thereby breaching its obligations under the U.S.-Argentina BIT).

166. See *id.* ¶ 242, 46 I.L.M. at 70 (interpreting Argentina’s response to the crisis as reasonable and recognizing the fact that it “considered the interests of the foreign investors” even though there was no requirement to do so).

167. See Sarah F. Hill, *The “Necessity Defense” and the Emerging Arbitral Conflict in its Application to the U.S.-Argentina Bilateral Investment Treaty*, 13 LAW & BUS. REV. AM. 547, 551-57 (2007) (explaining different interpretations of the doctrine of necessity as applied to military, humanitarian, environmental, and economic situations). Generally, the doctrine of necessity requires that the action is made to safeguard an essential national interest from peril where the action was not made by the state, although courts have denied reliance on the doctrine of necessity

Argentinean case is that moral hazard, at least of this type, played no role: if Argentina could have avoided the calamitous events, it clearly would have. The benefits that might result from the breach of contract did not play a part in the decisions that led to the crisis. Indeed, the government in power at the time acted reasonably—given the situation that it had inherited—to avoid a crisis. Its ability to maneuver was limited. And while it is difficult to anticipate future contract disputes that might result from macroeconomic collapses, it is hard to believe that moral hazard issues will be important. As such, there is no compelling case for “culpability” playing a determinative role in invoking the necessity defense. It does introduce an additional element of contentiousness, which is inherently ambiguous and impossible to resolve. There is neither experimental evidence nor a well-defined thought experiment that could ever resolve such an issue. Does it mean that there were policies which, if the government had followed them, would have prevented the disaster? Clearly, the debt default would not have occurred had the government not borrowed; but if the government had not borrowed, other problems would have arisen. What those problems would have been depends on what consequences would have resulted from failing to borrow. What expenditures would have been cut? If expenditures had not been cut, there would have been rampant inflation. What would have been the consequence? Even if the government had borrowed, it could have avoided defaulting on the contract, but with what consequences? Perhaps there would have been even more street protests than those that occurred. With what loss in life? How does one balance the profits of the utilities with this loss of life?

There is shared blame: Government policies were shaped by the IMF and the World Bank. Perhaps without their advice, Argentina could have avoided default. Is the arbitration panel supposed to answer this question, about which the most qualified economists have not reached agreement? The IMF pushed the countries to sign the contracts with the utilities, and these contracts themselves constituted

during financial crisis because of available alternatives to avoid the peril. *Id.* at 549-50, 555-57.

part of the reason for the collapse.¹⁶⁸ In this view, the utilities share culpability.

There is a further standard that has sometimes been invoked: Even if there is an intervention motivated by necessity, and even if the country bears no responsibility for the necessity, the “breach” should be performed in a way that is least costly to the investor. This is, I would argue, a totally inappropriate standard. Typically, there are trade-offs: reducing the costs to investors may increase the costs to other groups in society. Why should investors be “privileged” over all other groups? Indeed, doing so would breach any “fair and equitable treatment” standard, defined in any reasonable way—other than the narrowest construction, in which “fair and equitable” focuses exclusively on the interests of investors. Again, economic policies have a wide range of consequences to various groups; pursuing investor value maximization is *not* consistent with either maximizing social welfare or economic efficiency.

In the case of Argentina, it is clear that maintaining utility prices in dollars—while the rest of the economy was undergoing pesification—would have been a huge windfall for the utilities. It would have represented a vast redistribution of wealth from the rest of the economy to the utilities—resulting in an unfair and inequitable outcome.¹⁶⁹ It would have harmed the economy, depressing output even further: The losses to the rest of society would have significantly ex-

168. And even at the time, many thought that these contracts were poorly designed; there were important contingencies in which severe problems could and did arise. No one could have anticipated that in the event of those contingencies—a major devaluation of the currency—it would be likely that Argentina would be willing or able to continue to pay the utilities in prices pegged to the dollar. One can interpret the high profits the utilities received *before* convertibility (the fixed exchange rate system) as compensation for the losses that they would likely suffer afterwards. Otherwise, it is hard to justify the terms the investors received in these contracts.

169. See *CMS Gas Transmission Company v. Argentina*, Application for Annulment and Request for Stay of Enforcement of Arbitral Award, ¶21, ICSID Case No. ARB/01/8, 7-8 (Sept. 8, 2005) (explaining that the price of utilities would have increased dramatically without the changed tariff, depriving Argentines of power while ensuring huge profits for the foreign utility companies). *But see LG&E Energy Corp.*, ¶¶ 134, 266, 46 I.L.M. at 58, 73 (citing the argument that the freeze on utility companies was necessary to avoid further economic deterioration, but nonetheless holding that such treatment is “unfair and inequitable” per the terms of the U.S.-Argentina BIT).

ceeded the gains to the utilities.¹⁷⁰ No one, *ex ante*, thinking about what should have been done in this situation would have recommended maintaining prices in dollars.¹⁷¹

The standard of “least costly intervention” has been invoked in trade policy,¹⁷² and critics of its use in the context of BITs have argued that there is no basis in the agreements themselves for its invocation. But as a policy matter, even in the context of trade, I believe it is an inappropriate standard. I have already given one of the reasons: The least costly intervention may impose costs on others; as a matter of policy, one should not privilege “trade.” But, in addition, it imposes a standard of perfection not seen in any other area. Governments are imperfect; political processes are complicated; and the policies that emerge do so as a result of complex bargaining with imperfect and incomplete information. One has to believe that, in gen-

170. This was not just a zero sum game. Had the utilities gotten what they wanted, the losses to the rest of society would have been greater than the gains to the utilities.

171. One interpretation of what contract law should do, beyond enforcing contracts, is to fill gaps in incomplete contracts, thinking through what the parties might reasonably have agreed to had they thought through this particular contingency *ex ante*—recognizing that there are an infinity of contingencies; no contract can anticipate all of them.

172. Another approach that seems to be invoked in judging the reasonableness of an action that is analogous to that used in trade disputes is the reliance on “scientific” evidence. In trade, for instance, European objections to the import of genetically modified foods have been challenged on the grounds that there is no scientific basis for such objections (though the “precautionary” principle might suggest that, since there is, at least in the minds of many, some risk that cannot be fully ascertained, it should be permissible to restrict the import of genetically modified foods). Appellate Body Report, *European Communities—Measures Concerning Meat and Meat Products*, ¶¶ 196-197, WT/DS26/AB/R, WT/DS48/AB/R (Jan. 16, 1998). The question is, if citizens of a country wish to prohibit the sale of genetically modified foods, should they have the right to do so, even if it adversely affects a trading partner? Other areas of public policy are not subjected to such “scientific” discipline. Two NAFTA suits involved prohibitions against particular chemicals believed by many to have adverse health and environmental effects: *Methanex Corp.* for banning a gasoline additive known as MTBE, and *Ethyl Corp. v. Canada* for banning methylcyclopentadienyl manganese tricarbonyl. In the former case, there was evidence of adverse effects. See *Methanex Corp.*, 44 I.L.M. at 1415, 1462 (recognizing scientific data that MTBE threatened the safety of groundwater and dismissing Methanex’s claims based on lack of jurisdiction). In the latter case, there was little evidence of adverse effects. *Ethyl Corp. v. Canada*, Award on Jurisdiction, 38 I.L.M. 708, 730 (1999) (NAFTA/UNCITRAL June 24, 1998) (requiring Canada to pay compensation).

eral, governments undertake the best policies—balancing *all* of the interests, not just trade—that they can. It seems wrong to punish a country, either because of Monday morning quarterbacking by some arbitrary arbitration panel suggesting that they could have constructed a Pareto superior agreement, or because they believe more weight should have been given to trade decisions than was given.

The implication of the analysis of this section is that the inherent ambiguities in critical terms in bilateral agreements need to be interpreted from a broad perspective, one which takes into account not only the interests of investors, but also society more broadly, not only concerns about efficiency, but also those of social justice. Foreign commercial arbitration panels are simply not equipped to engage in the careful balancing and difficult judgments that are required.

We shall return to this point later.

C. MARKET INSURANCE

Regulatory takings provisions are designed to reduce the risks enterprises face when doing business. There are other ways with which risks can be dealt. Insurance markets are designed to assess and transfer risks from those less willing or able to bear it to those more willing and able. For the most part, there are no markets for insurance against the risks with which we are concerned in this paper;¹⁷³ and the absence of such markets can be viewed as a market failure. The existence of such a market would, at the same time, provide a benchmark against which the “takings” could be judged. If the premium were very high, it would reflect a general understanding that new regulations were anticipated and would accordingly have already been reflected in market prices, so that when such regulations are in fact passed, little compensation is required.

Governments have stepped in to fill the void in expropriation insurance, and arguably, countries negotiating bilateral investment agreements could set up an insurance fund for regulatory takings. Firms could be asked to pay premiums into the insurance fund,

173. Though, as already noted, there is insurance against explicit expropriation. See *infra* Part VI.

which would compensate them if specific regulations were enacted.¹⁷⁴

Note that compensating firms for not polluting creates a market distortion—for it encourages the entry of potential polluters.¹⁷⁵ The provision of insurance against regulation could be designed in such a way as to assess the adverse environmental (or other) impacts of the firm, forcing the firm to pay at least part of those costs through the premiums, thereby increasing economic efficiency.¹⁷⁶ If compensation is to be paid, there should be an insurance premium charged at the time the investment is made.

D. IMPLICATIONS OF THE SOVEREIGN FUND DEBATE

The G-7 has worried about purchase of assets by funds owned by foreign governments. In doing so, they are admitting that *ownership matters*, but their arguments seems to be the following: We understand private sector firms. They maximize profits. And standard market economics ensures that if firms maximize profits (shareholder value), society's well-being will be maximized. This will be true whether the owner is domestic or foreign. But a foreign government might have other objectives. It might want to weaken the host economy, especially in times of conflict.

There are several fundamental flaws with this logic, and by understanding these flaws, we can better appreciate the appropriate design

174. Governments might set premiums to reflect the likelihood of passage of various regulations—for example, a twenty percent premium for the passage of a regulation restricting the ability of toxic waste dumps to be established on a particular site. Note that if a government set the premium below the actuarial value, it must bear the cost.

175. See Coase, *supra* note 76, at 10-11 (arguing that it does not make any difference how one assigns property rights, as long as they are clearly assigned). This highlights one of the difficulties of the usual interpretation of the Coase Theorem; assignment cannot be to a class of potential individuals/firms (for example, smokers and steel companies) because the assignment may increase the numbers in that class. The assignment has to be to particular individuals or firms.

176. Not all regulations, however, should be viewed as attempts to control externalities. Some can be viewed as part of the provision of a public good. The ESA imposes costs on those unlucky enough to have a spotted owl nest in their tree. Some theoretical models in economics view public goods as an extreme form of externalities, where the increase in consumption of a good by one individual affects all others in an equivalent way.

of bilateral investment agreements. If the domestic economy is well regulated, then there is little to fear from the foreign investor. If he manufactures pencils, and there is a competitive pencil industry, then if he decides to pursue a non-profit maximizing strategy, he is hurt; but the rest of society is well protected by the workings of a competitive market place. The problem is that many economies are not well regulated. The foreign firm can become a dominant firm in some industry; it could use that dominance to exercise monopoly power, or to undertake risky actions that might lead to a government sponsored bail-out under the doctrine of “too big to fail.”¹⁷⁷ But the answer to these concerns is to strengthen anti-trust laws, not to preclude foreign ownership.

In the late 1990s, the United States privatized the U.S. Enrichment Corporation (“USEC”), a company that takes and enriches uranium.¹⁷⁸ Low enriched uranium is used in nuclear power plants; highly enriched uranium (“HEU”), made in the same process simply by continuing the enrichment process, is the key ingredient in making atomic bombs.¹⁷⁹ A private owner (whether foreign or domestic) has an incentive to sell HEU to the highest bidder, posing a real threat of nuclear proliferation. Because we worry about inadequacies in our regulatory structure—can we really fully supervise what the company does—there would be strong opposition to selling USEC to Libya, Iran, Iraq, or a host of other foreign owners. But these inadequacies should have made us equally wary about the sale to domestic private owners, who evidenced more concern about enhancing their profits than reducing the risk of nuclear proliferation.¹⁸⁰

177. See Kevin Dowd, *Too Big to Fail? Long-Term Capital Management and the Federal Reserve 2* (CATO Inst., Briefing Paper No. 52, Sept. 23, 1999), available at <http://www.trendfollowing.com/whitepaper/bp52.pdf> (defining the doctrine of “too big to fail” as “the belief that the Fed will rescue big financial firms in difficulty—for fear of the possible effects on financial markets of letting big firms fail”).

178. See Matthew L. Wald, *In an Unusual Deal, U.S. Will Sell Stock in Its Uranium Mills*, N.Y. TIMES, June 30, 1998, at A1 (reporting that the U.S. Government would sell the U.S. Enrichment Corporation in an initial public offering after it failed to sell to it a private company for a reasonable price).

179. Military Warheads as a Source of Nuclear Fuel, Nuclear Issues Briefing Paper 4 (Nov. 2007), available at <http://www.uic.com.au/nip04.htm>.

180. See STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS, *supra* note 136, at 176 (discussing a case in which the USEC secretly blocked the transfer of nuclear material from Russia to the United States, presumably because of fears of a de-

We recognize that in many of these vital areas, regulatory structures are inadequate, and we simply assume that domestic, private actors would never put their profit interests ahead of national interests; but even if they are loyal, they can—and are likely to—construe national interests in ways that minimize (perceived) potential conflicts with profit opportunities.

But even if owners are not malevolent—are not pursuing objectives that are patently contrary to national objectives—private owners can be irrational. They too may not necessarily be pursuing profit maximization, a fact particularly evident in certain sectors like media and sports. They may have different views of risks going forward. Accordingly, there is no assurance that their actions will lead to socially desirable outcomes. Again, strong competition and appropriate regulation allows us to put aside these worries.

In short, the debate over sovereign investment funds has highlighted concerns in developed countries that competition laws and regulatory structures are so imperfect that foreign ownership might exert a threat. But if that is the case, so too would private domestic ownership in certain sectors of the economy. While the “first best” remedy is to improve competition and regulation, it cannot be accomplished overnight, and, therefore, temporary restrictions may be desirable.

But if these arguments are valid for developed countries, they carry even more weight for developing countries. The competition and regulatory institutions of developing countries are much weaker and less developed. If politics matter, should not developing countries worry that foreign owners might take actions that reflect the perspective of the foreign government, especially when the foreign government has played a role in opening up access to the country (through the negotiation of a trade or investment treaty for exam-

pressing effect on the price of enriched uranium). Under the “swords to plowshares” agreement between the United States and Russia, the United States would buy the uranium to later be used in power plants in an effort to prevent nuclear proliferation and provide Russia with money, a practice that American uranium producers viewed as dumping uranium on the U.S. market. *Id.*

ple)?¹⁸¹ In such circumstances, it is especially clear where the loyalty of MNCs may lie.

Thus, the sovereign fund debate has highlighted the fact that *ownership matters*, but it will matter less as countries improve regulatory and competitive institutions. That means that developing countries in particular must have a wide scope to strengthen regulations. But regulatory takings provisions within investment agreements may narrow that scope: They help create conditions in which cross-border ownership is more problematic.

VII. STANDARDS OF COMPENSATION

The previous section explained why, as a matter of economic theory and practical politics, there should be no compensation for regulatory changes and for other legislative changes. There is a further argument against providing compensation for changes in regulation: The impact on values is highly speculative. Consider the consequences of changing a regulation to allow a toxic dump site in a village in a country in which common law actions can be taken against environmental damages, and in which punitive damages can be imposed. Should appropriate compensation for the new regulation take account of the likelihood that a tort action would follow if the firm actually used the site as a toxic waste dump? What kinds of punitive damages might be imposed? With what probabilities? Would the assessor of compensation have to judge which pollutants the firm might likely use and the value of the damage to the groundwater system? One of the reasons for *ex ante* regulation rather than *ex post* compensation is that it is often difficult to determine the appropriate levels of *ex post* compensation, and litigation costs are high.

Consider, moreover, the case of a country debating passage of a law regulating toxic waste dumps. With foreign firms—not domestic firms—protected with a regulatory takings provision, prices of toxic waste dump sites would be depressed as a result of the expectation of the passage of the law. A foreigner could then buy the land, and when the law is passed, demand compensation, though, in effect, the

181. Even if it is not a matter of simple national loyalty, governments and domestic firms are engaged in a “repeated game” calling for cooperative actions, especially in any arena the government considers important.

price was already discounted to reflect the expectation of the regulation.

In principle, one could argue that at the time of purchase, there was a reasonable expectation that such legislation be passed, so that he should not be compensated.¹⁸² But different individuals will differ in their expectations, and whose “reasonable” expectations should be used? For marketed assets, one could use changes in market values. In the example, there might be little change in market values since the market already reflected the expectation of the passage of regulations. But there are other factors affecting market value. If the demand for toxic waste dumps falls, say as a result of a tax on polluting chemicals, would the assessor of the damage caused by the regulation have to parse out what fraction of the loss in market value is due to the regulation and what fraction is the result of other factors?

What happens if the firm argues that the market underestimated the expected returns? After all, people who invest in a business are more optimistic about the returns than those who decide not to enter at all. The firm may even be able to produce numbers backing its claims. But the fact that others chose not to enter the business may reflect that those individuals are the most pessimistic.

The speculative nature of the requisite compensation is even clearer in the case of compensation for “pre-establishment” investments—when a foreign firm enters a country with the idea of potentially setting up a business. Engaging in this kind of exploration requires, of course, investment. But if, in the interim between initial exploration and undertaking an investment, a regulation passes making investment unattractive, what should be the basis of compensation? Should compensation be the loss of potential income had the investment been undertaken and proven successful? Or only the di-

182. See *Glamis Gold Ltd. v. United States*, State Department, <http://www.state.gov/s/l/c10986.htm> (last visited Feb. 20, 2008) (explaining that in this pending case, the United States is being sued by a (nominally) Canadian mining company that objects to back-filling regulations imposed upon open pit mines); *Glamis Gold Ltd. v. United States*, Statement of Defense of Respondent United States of America, ¶¶ 50-59 (NAFTA/UNCITRAL, Apr. 8, 2005), available at <http://www.state.gov/documents/organization/45118.pdf> (arguing that no investor could reasonably expect that regulations would remain static over the long haul, particularly in a historically highly-regulated sector like mining and highly-regulated jurisdiction like California).

rect loss of exploratory investment? Such potential returns are entirely speculative. There are a myriad of circumstances that might have interfered with achieving the “anticipated” returns—a recession, new products, or new sources of competition. Indeed, part of pre-establishment exploratory research should entail ascertaining the likelihood of a change in the regulatory environment. In a sense, a firm surprised by a change in the regulation is a firm whose pre-investment research was deficient. Why then should a government compensate it?

That is why most arbitration panels only compensate for past investments and not for lost “potential” business profits.¹⁸³ But even that standard opens up a hornet’s nest. The investor may have overpaid for the asset.¹⁸⁴ Many contract disputes involve complicated accounting issues: The firm may have undertaken the investment itself. Should it be allowed to attribute overhead in the head office to this investment? Should it only be compensated for incremental costs, in which case the claimant would have to prove that the expenditures incurred, were reasonable, and would not have occurred but for the project? Moreover, the value of the asset may have been high because the market simply did not expect the government to enforce environmental regulations; all that was required was a minimal bribe. Should a newly elected government be forced to pay foreign firms because a previous government was corrupt? Or even if the previous government was not corrupt, simply because it failed to enforce existing legislation?

Consider a country contemplating passing tort legislation that would hold corporations liable for environmental damages. A firm

183. See *S.D. Myers, Inc.*, Second Partial Award, *supra* note 132, ¶ 311 (awarding \$6.05 million plus interest to S.D. Myers, Inc. for lost business opportunity). This case was disturbing on two grounds: Compensation was provided not to a “real investor,” but simply to a firm engaged in business; and compensation was provided for lost profits. Were these standards to be sustained, potential liabilities under investment agreements could soar.

184. See *Azurix Corp. v. Argentina*, Award, ¶ 386, ICSID Case No. ARB/01/12 (July 14, 2006) (finding that Azurix, an Enron subsidiary, was induced into making a number of ill-considered investments, wildly overbidding for an Argentina concession). Argentina argued that after receiving the concession, Azurix planned to turn around and pressure Argentina into renegotiating the terms of the contract to recover the losses. *Id.* ¶ 199. Notably, the Tribunal took this into account and reduced significantly the lost profits which Azurix sought. *Id.* ¶¶ 425-433.

that had been planning to engage in unsound environmental practices may find the value of its project markedly decreased. Could the firm sue, demanding compensation for the *expected* decrease in the value of the “project”? Can it only sue after it has been sued, and then only for the damages it has to pay? But if it can recover the cost of any damage it imposes on others, the incentives provided to refrain from engaging in activities that damage others are totally undermined. If the market quickly capitalizes the expected value of compensations from litigation, property values will decrease. Should a firm be able to capture this decrease in property values? Again, doing so vitiates the *Polluter-Pays Principle*; gives the corporation, in effect, the right to pollute; and, given strong budgetary constraints,¹⁸⁵ results in political pressures preventing the adoption of robust regulatory and tort regimes. Indeed, cases have been brought (and won) demanding compensation because of inadequacies in regulatory and tort regimes existing at the time the investment was made.¹⁸⁶ In one famous case, a Mississippi court ordered a Canadian funeral homeowner to pay \$500 million in damages, of which \$400 were punitive damages.¹⁸⁷ Although the NAFTA tribunal believed that there was a violation of the minimum standard of treatment, the Tribunal rejected the claim on the more technical ground that the investor had not exhausted local remedies.¹⁸⁸

185. Most governments face tight budgetary constraints would be understandable, given the high costs of raising tax revenue.

186. See *MTD Equity Sdn. Bhd.*, Award, *supra* note 66, ¶¶ 163-166, 44 I.L.M. at 115 (concluding that Chile’s laws had failed to treat MTD Equity fairly in that the government, on the one hand, approved the location of the investment and, on the other hand, denied the investor the necessary permits to conduct business).

187. See *Loewen Group, Inc. v. United States*, Award, ¶ 4, ICSID Case No. ARB(AF)/98/3 (June 26, 2003), 42 I.L.M. 811, 812 (2003) (describing the extraordinarily high jury verdict from a Mississippi county circuit court).

188. See *id.* ¶¶ 241-242, 42 I.L.M. at 850-51 (explaining that the drafters of NAFTA did not intend for the tribunal to serve an “appellate function parallel” to domestic courts, but acknowledged the unfairness of the decision and the injustices suffered by the claimants); GUS VAN HARTEN, *INVESTMENT TREATY ARBITRATION AND PUBLIC LAW* 134 (2007) (explaining that although the Tribunal interpreted NAFTA to require exhaustion of local remedies, the text of NAFTA does not contain such an explicit requirement).

VIII. RIGHTS AND RESPONSIBILITIES

One criticism of bilateral trade agreements is that they focus more on the rights than the responsibilities of corporations.¹⁸⁹ For instance, corporations have, on a number of occasions, contributed enormously to environmental degradation, without repairing the damage. When the host country demands something be done, the firm (a subsidiary which has paid out all revenues in the form of dividends) declares bankruptcy, leaving the government to clean up the mess.

Limited liability was never intended to allow corporations to escape liability for such behavior.¹⁹⁰ In these cases, the corporate veil should be pierced, and the mother company should be responsible for clean-up. Any firm with a controlling share—twenty percent or more interest—should be liable. This would provide strong incentives for these firms to exercise oversight over the actions of the enterprise.¹⁹¹

Enforcing responsibilities across borders is often difficult. Even when a judgment is awarded, it may be difficult to collect if the MNC removes all assets from the jurisdiction in which the damage

189. The issue of responsibilities, as well as rights, is a factor in determining appropriate compensation. Many investment suits have entailed a breach on the part of the investor in fulfilling its obligations, with the inevitable dispute as to who is to blame for the breach. *See, e.g., Metalclad Corp.*, ¶¶ 48, 127, 40 I.L.M. at 43, 53 (sidestepping Mexico's allegations that the company had an obligation to clean up certain hazardous material on its site, which it failed to do). In determining appropriate compensation, the Tribunal totaled Metalclad's investments and expenses, but only mentioned remediation without calculating its total cost. *Id.* ¶ 131, 40 I.L.M. at 54.

190. Damage to the environment and to the health and safety of workers is only one example of the failure of corporations to live up to their responsibilities. Many concessions have provisions requiring firms to undertake certain levels of investment. Disputes often arise concerning whether firms have complied with these provisions. Sometimes the MNCs use accounting "tricks" to claim that they invested more than they actually have. *See ANDERSON & GRUSKY, supra* note 130, at 18 (explaining that Bechtel could not comply with its utility contract because Bolivia had not provided the requisite protection for its people and assets). Bechtel's management of the project had elicited massive protests. Some believe that strong civil society protests in the United States are responsible for Bechtel eventually dropping of the suit. *Id.*

191. Obviously, legal frameworks would need to be more complex to avoid the risk that all "owners," wishing to avoid responsibility, would maintain an interest of less than twenty percent.

or tort occurred. BITs should contain provisions for the enforcement of judgments in the host country against MNCs in the home country.

The asymmetry between rights and responsibilities in these treaties is paralleled by an asymmetry in the attitudes of MNCs and their major business lobby groups (National Foreign Trade Council, U.S. Council for International Business, and others) towards the protections to be provided by investment agreements, especially the right to sue foreign governments for alleged abuses of property rights, and towards Alien Tort Claim Act (“ATCA”) lawsuits which permit alleged victims of human rights abuses to sue corporations in U.S. courts. They excoriate these lawsuits. One of the major arguments against ATCA lawsuits is that they may unwittingly embarrass or anger governmental allies in the war against terrorism (for example, by exposing the wrongdoing of governments who have conspired with U.S. MNCs to abuse human rights) and thereby disrupt U.S. foreign relations.¹⁹² The same critics of the ATCA lawsuits abandon all pretense of concern for the feelings and sensibilities of U.S. allies when it comes to permitting corporations to sue those same governments under investment treaties. For example, these groups are lobbying hard for a U.S. BIT with Pakistan that could expose the Pakistani government to multi-billion dollar lawsuits by U.S. corporations, without any thought as to whether such embarrassing lawsuits might complicate U.S. foreign relations.

Indeed, in the case of Indonesia, the payment of an excess of \$300 million in the Karaha Bodas case, *where the power project was suspended in the midst of a national economic crisis*,¹⁹³ has become a

192. See Brief for United States in Support of the Petition at 7, *Sosa v. Alvarez-Machain*, 542 U.S. 692 (2004) (No. 03-339) (explaining the U.S. Government’s fears that the Alien Tort Claims Act may interfere with U.S. foreign relations and interfere with U.S. efforts to combat terrorism); Press Release, John E. Howard, Vice President of Int’l Policy, U.S. Chamber of Commerce, *The Alien Tort Claims Act: Is Our Litigation-Run-Amok Going Global?* (Oct. 2002), available at <http://www.uschamber.com/press/opeds/0210howarditigation.htm> (arguing for the repeal of the Alien Tort Claims Act because it interferes with American businesses abroad and U.S. foreign policy).

193. Todung Mulya Lubis, *Karaha Bodas Dispute Lingers, Until When?*, JAKARTA POST, Oct. 30, 2006, available at <http://www.kabar-irian.com/pipermail/kabar-indonesia/2006-October/012331.html>. Indeed, there is a widespread perception in Indonesia that the cancellation of the power infrastructure projects was encouraged, if not demanded, by the IMF. S.N. Vasuki, *IMF Official*

focal point of nationalists in opposition of foreign investment more broadly, and U.S. international economic policy more specifically.

We noted earlier that foreign firms may have less of an incentive to behave “responsibly” abroad than they do at home, where social pressures may be brought to bear. Worse still, they may use their disproportionate economic power to ensure that they receive protective legislation. Papua New Guinea even passed a law making it illegal to sue international mining companies.¹⁹⁴ This makes it all the more important that there be legal standards that demand that firms operating abroad behave in accordance with their domestic standards, enforceable with tort actions in the home country (an expanded aliens tort provision). This should be part of any BIT.¹⁹⁵

One of the problems in modern corporations is that management's incentives are distorted.¹⁹⁶ Management is seldom held personally liable. Management can gain, through implicit or explicit stock options or other incentive schemes, from engaging in environmentally destructive activities without paying the clean-up costs. Firms have an incentive to use limited liability to shift the burden of clean-up to the host government. Even if the firm is caught and forced to clean up, the management is unlikely to pay the price. The management in place when clean up occurs may not be the management in place at

Praises Jakarta For Its Steps In Tackling Crisis, BUS. TIMES (Sing.), Sept. 18, 1997, at 8.

194. See Aviva Imhof, *The Big, Ugly Australian Goes to Ok Tedi*, 17 MULTINATIONAL MONITOR 3 (Mar. 1996), available at <http://multinationalmonitor.org/hyper/mm0396.05.html> (discussing how companies participated in the drafting of the Papua New Guinea law, which drew international criticism).

195. One might ask whether this position is inconsistent with the earlier argument that it may be appropriate for there to be different standards in different countries. The concern is that developing countries are in a disadvantageous bargaining position vis-à-vis large MNCs, and that without such protections, MNCs may be able to use their economic and political power to the disadvantage of those (especially the poor) within the developing countries. The provisions called for in this section would serve to redress, to some extent, these imbalances.

196. I have discussed the broader issue of the distorted incentives facing management in *The Roaring Nineties*. See STIGLITZ, *THE ROARING NINETIES*, *supra* note 105, at 133-36, 264, for a discussion of the “perverse” incentives that confront both auditors and corporate executives. Stock options have, for instance, led to distortions in the information provided to the market. The Sarbanes-Oxley Act recognized the distorted incentives confronting accounting firms—a problem to which Arthur Levitt, then head of the SEC, had previously called attention—but did nothing about the stock option problems. SOX, *supra* note 28.

the time the environmental degradation occurred. In short, the compensation schemes confronting most CEOs and their management teams are not designed to lead to the maximization of shareholder value; but even if they were so designed, the maximization of shareholder value does not coincide with the maximization of societal welfare in the presence of limited liability. It is appropriate that the legal frameworks that govern incorporation—including the rights of foreign companies doing business within a country—try to correct these “market failures.”

But governments need to go beyond this: they must hold officers criminally liable when their companies violate the law, including those laws that govern the environment and worker safety and health. Corporations do not take actions: it is individuals within the corporations who take actions. But it is all too easy for no one to take responsibility. CEOs get paid handsomely; they are quick to take responsibility for increases in share values, even when those increases are largely accounted for by events beyond their control (like the rise in oil prices giving rise to record profits by firms in the oil industry), but slow to take responsibility for mistakes.

To implement this in a world of MNCs requires a willingness of countries to extradite those accused of such crimes; this should be an essential part of any multilateral investment treaty.¹⁹⁷ The fact that it is never so included reflects the unbalanced nature of these agreements. There should also be provisions which allow the enforcement of judgments against individuals and corporations in their home ju-

197. For instance, the United States refused to extradite (without explanation) the officials of Union Carbide, so that they could stand trial in India for the Bhopal disaster in which thousands were killed and hundreds of thousands were injured. No one from Union Carbide has been held accountable, and the compensation paid to the innocent victims is widely viewed as grossly inadequate. See *In re Union Carbide Corp. Gas Plant Disaster at Bhopal*, 634 F. Supp. 842 (S.D.N.Y. 1986), *modified*, 809 F.2d 195, 197 (2d Cir. 1987) (affirming the dismissal of the case to India on *forum non conveniens* grounds so that the case may be brought in India, but not requiring extradition of individuals). The \$470 million settlement paid by Union Carbide has been challenged, so far unsuccessfully, on various grounds in U.S. Federal Courts. See *Bano v. Union Carbide Corp.*, 198 Fed. Appx. 32, 34 (2d Cir. 2006), for the most recent ruling dismissing the appeal from District Court under the Alien Tort Claims Act and holding that the plaintiff could not allege property damage since the plaintiff was not a legal property owner.

isdiction—including corporations that are deemed to have controlling interest (twenty percent or more).

IX. DISPUTE RESOLUTION

No matter how well contracts and treaties are written, there will be disputes, and these disputes will have to somehow be adjudicated. The investment treaties have given rise to a large number of disputes; the fact that so many people are affected, so many principles are at stake, and that the language of the treaties leaves so many ambiguities would have suggested that the treaties would have paid careful attention to the design of an appropriate mechanism for dispute resolution. In fact, the processes for adjudicating disputes have been of particular concern and are widely viewed as one of the main flaws of these treaties.

As one of the leading scholars on investment treaties has concluded:

Consensual arbitration is broadly suitable as a means to settle disputes between companies or between states, but it is fundamentally inadequate as a substitute for public courts in the regulatory domain . . . [T]he courts *and only the courts* should have the final authority to interpret the law that binds sovereign power and to stipulate the appropriate remedies for sovereign wrongs that lead to business loss.¹⁹⁸

[T]he advent of investment treaty arbitration stands out, not as the vanguard of a broad movement to protect individuals in international law, but as an anomalous and exceptionally potent system that protects one class of individuals by constraining the governments that continue to represent everyone else.¹⁹⁹

Western democracies have developed a set of standards concerning due process—including standards of evidence and procedures—designed to increase the likelihood of a fair outcome. Trials are held in open court; in cases presenting novel issues, extensive written decisions weigh the arguments; appellate procedures exist to review the deliberations. Participants may, under certain circumstances, call for a jury trial. All of this is costly and time consuming, but there is a

198. VAN HARTEN, *supra* note 188, at 11.

199. *Id.* at 10.

consensus that such procedures, in enhancing the likelihood of a just and fair decision, are worth the cost.

The dispute adjudication processes in BITs often fall far short of these “best practices.” Arbitration often occurs behind closed doors.²⁰⁰ In some cases, even the occurrence of a dispute is kept secret, let alone its resolution. Appeals may be limited,²⁰¹ and there is no way of resolving contradictory decisions.²⁰² Since the decisions in some cases are not published, other cases cannot build on precedent. All of this adds an extra layer of uncertainty and capriciousness to the decisions. While BITs were designed to reduce uncertainty, in some ways they have had just the opposite effect.

There are other faults to the process of dispute resolution. As noted, there is no effective appellate process and no way of resolving contradictory rulings. This is especially important given the limitations commented on above in the arbitration panels themselves. In trade disputes, the WTO has created an appellate body, which has demonstrated an ability to look beyond the more narrow confines in which many of the originating dispute panels have been mired.

There are also serious concerns with the way arbitrators are selected. Arbitrators are not employed full-time, and often are representing parties in other cases where related issues are in dispute.²⁰³ The way arbitrators are appointed may expose them to undue political pressure. As Van Harten argues, “[t]here can be no rule of law without an independent judiciary.”²⁰⁴

200. Recent decisions suggest some improvements in the processes. In *Methanex Corp.*, the NAFTA panel allowed an amicus curiae filing and agreed to an open hearing. *Methanex Corp.*, 44 I.L.M. at 1347. The parties agreed to open hearings, except in one specific matter where Methanex insisted on secrecy. *Id.*

201. Only three NAFTA cases have been appealed, and in only one was any action taken. In *S.D. Myers, Inc.*, a case involving a U.S. waste disposal firm challenging a temporary Canadian ban on the disposal of toxic waste, the appellate court narrowly circumscribed grounds for appeal. *See Canada v. S.D. Myers, Inc.*, [2004] F.C. 38, ¶¶ 55-56 (Can.) (upholding the NAFTA tribunal’s decisions because they were not “‘patently unreasonable’, ‘clearly irrational’, ‘totally lacking in reality’ or a flagrant denial of justice”).

202. *See supra* note 40 and accompanying text.

203. Argentina has also even raised the question of a conflict of interest in the ICSID itself; it is part of the World Bank, and yet Argentina has an ongoing debtor relationship with the World Bank.

204. VAN HARTEN, *supra* note 188, at 174.

The underlying problem is the extension of arbitration principles designed for resolving commercial disputes among parties to arbitration between states and private parties (investor-state disputes). As the Tribunal put it forcefully in *Loewen*:

It is true that some aspects of the resolution of disputes arising in relation to private international commerce are imported into the NAFTA system [This] has tended in practice to make a NAFTA arbitration look like the more familiar kind of process. But this apparent resemblance is misleading. The two forms of process, and the rights which they enforce, have nothing in common. There is no warrant for transferring rules derived from private law into a field of international law where claimants are permitted for convenience to enforce what are in origin the rights of Party states.²⁰⁵

Unfortunately, many, if not most, tribunals have not understood these distinctions. Whenever states are party to a suit, issues of national interest may well arise, and as we have repeatedly seen, this has been particularly true in a large number of disputes under the investment treaties. Basic principles of good governance include citizens' rights to information (embodied, for instance, in America's Freedom of Information Act);²⁰⁶ open courts have been a mainstay of good jurisprudence. When the interests of so many are at stake, it is important that others who might be affected have the right to file amicus curiae briefs. It is understandable why corporations prefer non-transparent arbitration processes: Arbitration has a record of providing more protections than judges in the courts of either the host country or the country of the investors. But that reflects the fact that such arbitrators are often less sensitive to the social context in which "fair" decisions ought to be reached.

This is evident, for instance, in cases involving countries passing legislation intended to provide greater equality of opportunity such as South Africa's Black Economic Empowerment Act (affirmative

205. *Loewen Group Inc.*, ¶ 233, 42 I.L.M. at 849.

206. See generally Joseph E. Stiglitz, *On Liberty, the Right to Know, and Public Discourse: The Role of Transparency in Public Life*, in GLOBALIZING RIGHTS: THE OXFORD AMNESTY LECTURES 1999, at 115, 115-39 (Matthew J. Gibney ed., Oxford Univ. Press 2003) (arguing that government secrecy entails adverse effects on political processes undermining the basic tenets of democracy).

action legislation).²⁰⁷ Such legislation has played an important role in housing markets, labor markets, and credit markets in the United States. Yet, arguably, such legislation does have adverse effects on profits in the short run (otherwise firms would have presumably hired more of the disadvantaged individuals). In judging the legality of such legislation, courts have had to carefully balance a variety of rights, and different courts have sometimes come to different views.²⁰⁸ These are complex and divisive issues that in the end will have to be resolved by the highest courts of each country. Each country should have the right to come to a view on these issues within its own judicial procedures; they should not be short circuited by a commercial arbitration panel that is not likely to be sufficiently attentive to the broader societal issues raised by such restrictions.²⁰⁹ Parties should only look to alternate venues when there is a clear failure of the domestic courts.²¹⁰

207. Broad-Based Black Economic Empowerment Act 53 of 2003, Bill 27-03 (GA) (S. Afr.).

208. Compare *Wittmer v. Peters*, 87 F.3d 916, 921 (7th Cir. 1996), *cert. denied*, 519 U.S. 1111 (1997) (allowing a prison to use racial preferencing in hiring guards), with *Lutheran Church-Missouri Synod v. FCC*, 141 F.3d 344, 356 (D.C. Cir. 1998) (adopting a more limited interpretation of permissible affirmative action initiatives and finding the FCC's regulation requiring radio stations to use affirmative action employment policies unconstitutional).

209. This proposition will be played out soon, as several Italian investors in South Africa's mining industry have commenced proceedings at the ICSID, claiming that the Broad-Based Black Economic Empowerment Act violates the terms of the BITs that Italy and Belgium-Luxembourg have with South Africa. See LUKE ERIC PETERSON, SOUTH AFRICA'S BILATERAL INVESTMENT TREATIES: IMPLICATIONS FOR DEVELOPMENT AND HUMAN RIGHTS: OCCASIONAL PAPER NO. 26, at 17 (IISD 2006) (reciting the investors' allegations of expropriation and violations of national treatment); IISD, *Analysis: South African Arbitration May Raise Delicate Human Rights Issues*, INV. TREATY NEWS (Feb. 14, 2007), http://www.iisd.org/pdf/2007/itn_feb14_2007.pdf (suggesting that the investors have chosen arbitration, rather than the South African court system, because of the potential for greater compensation where constitutional limitations will not be imposed). This case has yet to be resolved by a tribunal, and it may be that the arbitrators show special concern for the social context given the publicity it has attracted. But as Peterson has pointed out, arbitrators often are not aware of the local context of investments. See PETERSON, *supra*, at 10-11 (noting that arbitration tribunals may receive little guidance in interpreting the often open-ended and ambiguous investment treaties).

210. Investment treaties often throw the entire domestic court process out the window and allow investors to leap-frog directly to international arbitration. *But see Loewen Group Inc.*, ¶¶ 3-7, 42 I.L.M. at 812 (appealing a Mississippi state

Similarly, courts on occasion have to decide whether contracts should not be enforced as a result of *force majeure*.²¹¹ Argentina's crisis of 2001 highlights the issues. In the crisis, contracts were breached; it was clear from the interest rate charged that debt contracts had some expectation that they would be breached. It is not clear whether arbitrators have the ability to judge the full societal consequences of what would have happened had all the utility contracts been honored and whether they have the broader societal sensitivities to make the appropriate judgments, even if they had analyzed the consequences appropriately.

This discussion illustrates the complex trade-offs between the rights of different individuals and groups in society. Honoring the rights of the owners of utilities would have decreased the ability of

court decision claiming that the state court violated provisions of NAFTA). Moreover, there is a tendency in some, but not all cases, for tribunals to take a very strict review of domestic measures (for example, not taking into account the political give-and-take and imperfections that are necessarily part of any domestic legislation or regulations). This is an evolving issue, but there is growing recognition, including by international lawyers, that some arbitrators are not inclined to follow the example of other international courts and tribunals to show some degree of deference when it comes to second-guessing the decisions of elected governments. *See, e.g.*, Jeffrey W. Stempel, *Keeping Arbitrations from Becoming Kangaroo Courts*, 8 NEV. L.J. 251, 258, 264-68 (2007) (suggesting that arbitrators ignore courts because the arbitrators often lack neutrality, and recommending a default rule that requires arbitrators to apply substantive law as one way to improve the arbitration system).

There are some obvious examples where domestic courts fail. In Zimbabwe, there appears to be a complete lack of effective domestic recourse for those who have been stripped of property. *See* Human Rights Watch, *Africa Overview: Silencing the Critics*, in *WORLD REPORT 2002*, at 11 (2002) (reporting on Zimbabwe President Robert Mugabe's indifference toward legal norms by citing the seizure of white-owned land).

In the realm of international human rights law, domestic courts are entrusted to resolve these issues in the first instance, with only a limited role for international tribunals on the margins, and only after the local court processes have been exhausted. Later, I discuss an alternative framework, which might work in the absence of an international commercial court.

211. *See* *Florida Power & Light Co. v. Westinghouse Elec. Corp.*, 517 F. Supp. 440, 459 (Dist. Ct. E.D. Va. 1981) (recognizing *force majeure* clauses as excusing non-performance for reasons "beyond the parties' reasonable control," but holding such a clause not applicable to the circumstances at issue). *See* Paul L. Joskow, *Commercial Impossibility: The Uranium Market and the Westinghouse Case*, 6 J. LEGAL STUD. 119 (1977), for a discussion of the underlying economics and law.

government to honor its implicit or explicit obligations to other societal claimants, such as retirees.

In U.S. bankruptcy law, Chapter 9 deals with the bankruptcy of public authorities, and it is in some ways markedly different from other Chapters (like 7 and 11) that deal with private bankruptcies.²¹² In particular, it provides priority to the continuation of the public functions of the public authority, explicitly recognizing public claimants, even if they have no formal “contract.”²¹³ Again, it is not clear that the arbitrators have approached their decisions within this frame; but it is clear that the language is such as to give them latitude to ignore these broader public policy concerns.

A. BETTER PROCESSES FOR DISPUTE RESOLUTION

It is understandable that investors will be skeptical of relying on host country courts; such courts may be viewed as excessively sensitive to domestic considerations and may treat foreign corporations unfairly. Even in the United States, litigants spend considerable energy and money searching for the most favorable venue.²¹⁴ Forum shopping is important because litigants believe that the outcome will be affected by the jurisdiction in and laws under which the case is tried—home court advantage.²¹⁵

That is why there is a need for an international commercial court consisting of full-time international judges—of the highest qualifications, without any commercial attachments, and not subject to the kinds of conflicts of interests for which the arbitration processes under the BITs have been so roundly criticized—to adjudicate cross-boundary disputes and enforce cross-boundary contracts and regulations. Such courts should be governed by the highest standards of

212. 11 U.S.C. §§ 7, 9, 11 (2000).

213. See 11 U.S.C. §§ 903-904 (2000) (allowing states to continue their authority over municipalities without interference from the bankruptcy courts).

214. See, e.g., *Syncom v. Brooks*, 1987 U.S. Dist. LEXIS 6723 (N.D. Ill. July 21, 1987) (granting motion for attorney’s fees even when litigant clearly engaged in forum shopping).

215. See Richard Maloy, *Forum Shopping? What’s Wrong with That?*, 24 QUINNIPIAC L. REV. 25, 27 (2005) (providing a trial lawyer’s perspective to convenience, expense, and sympathetic jury pools among the factors that make venues more or less appealing).

due process, including transparency.²¹⁶ There should also be appellate processes.

Courts should interpret disputes within the laws of the host country, giving deference to decisions made in the public interest—for example, concerning the environment, labor, social regulations, *force majeure*, and recognizing the conflicts of formal and informal claimants, and the primacy of public claimants—as the United States itself has done in Chapter 9 of its Bankruptcy code.²¹⁷

As commerce becomes increasingly globalized, the need for such courts will undoubtedly increase. It is hard to conceive of the U.S. economy functioning without a *federal* court system, that is, simply relying on state courts for dispute resolution. But at least within the United States, it is *relatively* easy to enforce judgments across borders. In the next section, I argue that with global markets, there is a need for global anti-trust actions.²¹⁸ And the best way to do this is by establishing a global competition court, with competition standards corresponding to the strongest prevailing in the world.

Until such international commercial courts are created, and until investors can gain confidence in the judiciaries in the host countries, there needs to be a third alternative, to which I referred earlier. Plaintiffs from developing countries should have the right to sue in the home country, using the standards of either the host or home country, for damages resulting from torts, anti-competitive behavior, etc. If the defendants from the home country claim, as a defense, that the courts of the host country are biased, then they should be willing to defend a suit in the home country, using the higher of the standards of the host and home country.

216. Note the difference between the approach taken regarding criminal justice under the International Criminal Court and commercial cases. In the case of the International Criminal Court, the matter is only turned over to the international tribunal after domestic courts fail to take action. By contrast, the arbitration panels under the investment treaties appear to trump domestic courts.

217. See 11 U.S.C. §§ 901-946 (2000).

218. See generally STIGLITZ, *supra* note 1, at 201-10 (suggesting a global competition law, a global competition authority, and support for global class action suits as effective means to deal with “economic globalization outpacing political globalization”).

In short, these investment treaties have been asymmetric: They have enforced rights without responsibilities and protected investors, but not others in the host countries.

X. TOWARDS REGULATING MULTINATIONAL CORPORATIONS GLOBALLY

Just as making economic globalization work requires an international commercial court, it also requires improvement in the regulation of MNCs globally. We noted in the beginning that one of the problems facing many small, poor countries in their attempt to regulate large MNCs is that the economic power of the latter may be much larger. There is another compounding problem: When problems are global in nature, it is inefficient to address them piecemeal, in a fragmented way. Of course, MNCs may prefer that; while it may increase their legal costs, it may also increase the likelihood that they will prevail or that actions will not be brought against them. Maintaining the public good is a public good; and maintaining the global public good is a global public good. There will, accordingly, be an undersupply of such services.

For instance, the maintenance of competition is essential for the efficiency of a market economy. The benefits that accrue to a firm like Microsoft in engaging in its anti-competitive practices accrue globally. Yet any national prosecution typically looks only at the damages incurred within its borders. Small countries may find it unprofitable to bring a case to recover damages that have occurred within their borders. Just as there is an argument for the consolidation of cases in class action suits, there is an argument for the consolidation of cases globally. In some cases, countries have tried to reach out beyond their borders, but, in most cases, courts have expressed a reluctance to do so. Thus, in *F. Hoffman-La Roche, Ltd. v. Empagran*, the U.S. Supreme Court did not allow foreign litigants to proceed in an anti-trust civil action, after the defendants reached an agreement with the U.S. plaintiffs.²¹⁹ I wrote an amicus curiae brief explaining that without global anti-trust action, market participants, as they weighed the expected costs and benefits of engaging in illegal anti-competitive behavior, would have an incentive to engage in

219. 542 U.S. 155, 159 (2004).

such behavior on a global scale, knowing that at most they risked significant punishment in the United States and a few other jurisdictions.²²⁰ In a modern economy, in fact, such behavior can only be effective if it is conducted on a global scale. *F. Hoffman-La Roche, Ltd.* raises the possibility that the consolidation of cases in any single jurisdiction could be easily vitiated simply by the defendants settling with the plaintiffs within that jurisdiction.

In spite of the need for a better international framework for governing cross-border activities—including the activities that occur within one country but generate externalities outside the country—we do not have an international political framework that can impose appropriate regulatory constraints (for example, on the emission of carbon). As I have said elsewhere, economic globalization has outpaced political globalization. We have a patchwork of institutions and agreements, among which are counted the investment agreements which are the subject of this paper. But as we note below in Part XIII, the political processes used to arrive at these agreements are flawed and undemocratic. This means that the scope of these agreements should be as narrow as possible, dealing only with those issues that are of the utmost importance, and where standardization and international protections are absolutely necessary.²²¹ The previous discussion should have made clear that the investment agreements have gone well beyond this.

XI. NON-DISCRIMINATION

If countries must sign investment agreements, they should be narrowly focused on the issue of discrimination. Companies entering a foreign country worry most about discrimination—both explicit discrimination (not being allowed to do business) and implicit discrimination (passing laws that differentially affect the types of businesses foreigners practice). As I previously commented, all countries engage in some discrimination. U.S. government officials, for example,

220. Brief of Amici Curiae Economists Joseph E. Stiglitz and Peter R. Orszag in Support of Respondents at 3-4, *F. Hoffmann-La Roche, Ltd. v. Empagran S.A.*, 542 U.S. 155 (2004) (No. 03-724), 2004 WL 533934.

221. See STIGLITZ & CHARLTON, *supra* note 5, at 68 (arguing that trade agreements should be narrowly circumscribed).

are required to fly using U.S. carriers.²²² Such discrimination is not surprising: Politicians are more sensitive to voters and campaign contributors, and most countries do not allow foreign firms to make campaign contributions. But the possibility of such discrimination adds risk to cross-border investment, and thereby adversely affects global efficiency.

BITs should focus on proscribing direct discrimination. Inevitably, however, legislation affects people differently; the fact that foreign investors may be hurt disproportionately should only be relevant if it can be shown that discrimination was the primary purpose of the legislation—that is, there was not a legitimate public purpose.²²³

Such non-discrimination provisions will provide much of the security that investors need without compromising the ability of democratic governments to conduct their business. Few governments will raise taxes to a confiscatory level, because they know that in doing so, they will kill the economy; but they might raise taxes on foreign businesses to a confiscatory level, knowing that domestic businesses might willingly enter in their stead.

The real danger of the bilateral investment agreements is that they introduce an element of reverse discrimination: Foreign firms are treated more favorably, with greater protections, than domestic firms.²²⁴ This disadvantages small domestic firms, adversely affect-

222. 49 U.S.C. § 40118 (2000).

223. Similarly, during financial crises where domestic and foreign creditors have claims to the assets of domestic firms, the principles that guide such resolutions will inevitably have differential effects on domestic and foreign claimants. For instance, in the 1997-1998 Korean crisis, domestic creditors had lent against collateralized assets, while foreign creditors had lent, unsecured, to the “mother” company. This resulted in Korean claimants recouping a larger fraction of what was owed. But this was not discrimination. Pressure was put on Korea to change the prioritization of claims to ensure a “fair” outcome between domestic and foreign creditors. See *Daewoo Group: Foreign Creditors Cry “Unfair Treatment”*, in 2 TROUBLED CO. REP. (Korea), Sept. 30, 1999, http://bankrupt.com/TCRAP_Public/990930.MBX (reciting foreign creditors’ claims that the Korean government gave “preferential treatment” to domestic banks during the crisis). In my judgment, that was wrong.

224. There is an argument for such discrimination: The elasticity of supply of foreign firms may be greater than that of domestic firms. There is a reverse argument: The government has a variety of instruments by which it can rely on domestic firms to behave consistently with broader national policies and objectives, meaning that the social returns to domestic investment may well be substantially

ing the development of the economy—large domestic firms can easily get the same protection as large foreign firms, simply by incorporating abroad.

There is an additional adverse effect: It weakens the demand for the rule of law and the creation of appropriate protections domestically. Once foreign firms have this advantageous position, they will have less incentive to lobby for broader investor protections; indeed, they actually will benefit from the maintenance of their favorable position.

XII. LEGAL EVOLUTION

In Part X, I argued for the creation of an international commercial court. This is particularly important because in some cases, the interpretation of the language of an investment agreement (or an investment chapter of a “trade” treaty) seems to have gone well beyond what at least many of those who voted for the agreement (or Administration officials who supported the agreement) thought at the time of passage. But because of the difficulties of amending treaty language, the “law” made by such interpretations can have long-lasting effects.

More is required than just the creation of a court: There needs to be some way of adapting the law, to ensure that the courts interpretations are consistent with prevailing mores and with changing conditions.

The appropriate legal evolution is thus of critical importance. Judges are given enormous power in the interpretation of language as well as the judgment of facts. A mistake in the judgment of facts may have great consequences for the parties involved (and a concern for justice means that we want to limit the scope for error, which is why appellate processes are essential); but a mistake in interpretation, in defining the “law,” what a phrase like “fair and equitable” might mean, can have far-ranging consequences, not only in later related cases but in altering incentives. Recognizing the fallibility of individuals, no reasonable system of decision-making would leave such important decisions in the hands of a small panel of judges, especially where at least one member of the panel is chosen without any

higher than those from foreign investment. On balance, I believe that with few exceptions it is a mistake to provide preferential treatment to foreign firms.

explicit commitment to ensuring that broader public interests are taken into account.

In fact, one can view legal evolution as involving decision-making by large groups of individuals, each group making decisions based on the knowledge and interpretations of the previous groups. When the line of reasoning thus developed falls out of kilter with social mores or broader perspectives on economic and societal concerns, there is a change, either by a higher court or the legislature. U.S. law, and the law of other democracies, is subjected to strong democratic political processes; if a court's interpretation deviates from the intent of the legislature, a democratic process is in place to correct such "misinterpretations."

One of the major failings of the treaty approach is that there is no easy way of making corrections and adaptation, even minor "corrections" of the kind that are standard in legislation; amending a treaty is far more difficult than amending legislation. Economic legislation (regulation) is particularly subject to fads and fashions: The neo-liberal doctrines that underlie much of the thinking of the past quarter century quite likely will go out of fashion, but it will not be easy to make the necessary changes in the agreements.

XIII. THE POLITICAL PROCESSES UNDERLYING BILATERAL TRADE AGREEMENTS AND RELATED AGREEMENTS

The critique of the BITs provided here, however, is more fundamental: The political processes by which such treaties are made short-circuit much of the normal political discourse, in which various interests are balanced. The negotiations are often conducted in secret. In the United States, a fast track process means the treaty must be voted up or down—no amendments are allowed.²²⁵ Corporate interests are actively engaged in the secret negotiations; the secrecy only serves to preclude active participation from others, whose viewpoints might differ. The result is agreements that are far different—

225. J.F. HORNBECK & WILLIAM H. COOPER, CRS REPORT FOR CONGRESS, TRADE PROMOTION AUTHORITY (TPA): ISSUES, OPTIONS, AND PROSPECTS FOR RENEWAL 1 (2008).

reflecting particular corporate interests—than would likely have emerged in a more democratic debate.

I witnessed this in the years I served on the CEA, years which saw the passage of NAFTA and the conclusion of the Uruguay Round negotiations. As I have already suggested, had there been a sense that there was a provision within NAFTA that might possibly be interpreted as a regulatory takings measure, at the very least, there would have been a side-letter to clarify the U.S. government's position on the provision. But not only was there no discussion of the full import of Chapter 11, it is not even clear the extent to which senior people in the U.S. Trade Representative's Office were aware of such an interpretation.²²⁶

The same could be said for the Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS"), which both the CEA and OSTP opposed; we believed that it was bad for American science, bad for global science, and bad for developing countries. But there was little public debate and little awareness of the nature of the agreement, which was largely shaped by the entertainment and pharmaceutical industries, with virtually no consultation from the U.S. academic scientific community or the user communities that might be affected. TRIPS was designed to reduce access to generic versions of pharmaceutical drugs, including life saving medicines. The implications were not fully realized until developing countries, like South Africa, pressed the case on access to generic AIDS medicines; the resulting hue and cry eventually led to a modification of the agreement.

226. As noted earlier, the agreement had been largely negotiated and agreed upon during President George H.W. Bush's administration. The secrecy and complexity of these agreements has served some of the negotiators well. Having written complex agreements, they enter into private practice to litigate them. This is illustrated by one of George H.W. Bush's negotiators for Chapter 11, Dan Price, who, after leaving the Administration developed a very lucrative practice using these BITs for arbitration (acting on behalf of Vivendi, Cargill, Allianz and others) that capitalized on the investor-state arbitration provisions. *See supra* note 22. In the ever "revolving door" so common in Washington, D.C., Price was then appointed as Deputy National Security Advisor for International Economic Affairs in the George W. Bush White House. Press Release, Office of the Press Secretary, The White House, Personnel Announcement (May 31, 2007), *available at* <http://www.whitehouse.gov/news/releases/2007/05/20070531.html> (last visited Feb. 2, 2008).

CONCLUDING REMARKS

Corporations are legal entities governments create to enhance the well-being of their citizens by producing certain conditions that are conducive to investing and conducting business. Governments grant certain rights—limited liability—but we have argued that these are not “natural rights” or “human rights” but only instrumental rights, shaped to further societal goals. Thus, the corporate veil can and should be pierced under certain circumstances; limited liability is not intended to make corporations or their officers immune from responsibility for their actions, including environmental damage. Governments have the right and responsibility to pass corporate governance laws, bankruptcy laws, and health, safety, and environmental regulations to further the well-being of their citizens. Foreign individuals and corporations wishing to conduct business within a country should be subject to the rules and regulations of the host country, including the rules and regulations that govern incorporation and bankruptcy. Hence, it is reasonable for governments to require foreign corporations operating within their borders to establish subsidiaries, whose governance and dissolution would be governed by national laws.

BITs and the investment provisions of many bilateral trade agreements provide protections for foreign firms that go well beyond those afforded to domestic firms, pay more attention to rights of corporations than their responsibilities,²²⁷ and include dispute resolution mechanisms that fall far short of the standards that we have come to expect of judicial processes in modern democracies. The result is that they have actually increased the degree of uncertainty—when one of the main arguments for these agreements was a reduction in uncertainty.

The consequences of BITs may go beyond the direct costs of the compensation paid and the often huge legal bills poor countries face in defending themselves. While BITs have not eliminated the uncer-

227. This is not the only asymmetry. We have also noted that corporations *can* recover losses from changes in regulations, but governments *cannot* recover corporate gains as a result of changes in regulations. Indeed, we argued that the adoption of a BIT itself (in the expansive interpretation) constitutes a change in the assignment of property rights (relative to what they had been), thus enhancing asset values.

tainty facing firms, they have heightened the uncertainty facing governments—the magnitudes of some of the settlements can have significant budgetary consequences for developing countries. It is not clear that these governments are the best providers of risk-mitigation services.²²⁸

These agreements have undermined democratic processes, circumscribing what democratic governments can and should do to enhance the well-being of their citizens. They can have a chilling effect on social and environmental regulation and legislation. There is no coherent economic theory underlying these agreements; on the contrary, modern economic theory requires more active intervention in the economy than these agreements call for. Indeed, these agreements are, to a large extent, reflective of deficiencies in current democratic processes; they risk preserving existing inefficiencies and inequalities by making it more difficult for democratically elected governments to correct past market failures and social injustices. Regulatory takings provisions inhibit legitimate government efforts in environmental, health, and employment regulation; other provisions (at least as interpreted by some arbitration panels) inhibit governments in taking actions to protect their citizens and promote the well being of their country in the context of crises, where *force majeure* may necessitate the abrogation of existing contractual arrangements.

These agreements were sold as simply protecting property rights; but from the start, their intent was to go well beyond that, and they have, at least in a number of instances, succeeded in doing so. There are international human rights conventions which offer some, albeit more limited, protection for “property rights.”²²⁹ Those conventions

228. Especially if they charge appropriate premiums.

229. See Universal Declaration of Human Rights, G.A. Res. 217A, art. 17, U.N. GAOR, 3d Sess., 1st plen. mtg., U.N. Doc. A/810 (Dec. 12, 1948) (protecting an individual’s right to own property); African Charter on Human and People’s Rights art. 14, June 27, 1981, O.A.U. Doc. CAB/LEG/67/3rev.5, 21 I.L.M. 58 (1982) (protecting an individual’s right to property, but allowing interference with this right for reasons of public interest); see also International Covenant on Economic, Social and Cultural Rights art. 11, Dec. 16, 1966, 993 U.N.T.S. 3; International Covenant on Civil and Political Rights art. 17, *opened for signature* Dec. 16, 1966, 1966 U.S.T. 521, 999 U.N.T.S. 171 (entered into force Mar. 23, 1976) (providing an indirect right to property through protection of an individual’s rights re-

were drafted to ensure that governments would not be prevented from regulating property in the greater public interest. The scandal of these investment treaties is that they circumvent that architecture of (balanced) human rights treaties and conventions, and set up a one-dimensional series of international agreements focused myopically on protecting property and assets, especially those of MNCs. Had these treaties been arrived at in a more open, transparent, and democratic process, arguably that is the kind of agreement that would have emerged. But these agreements, reached behind closed doors, are special interest treaties, enabling large corporations to achieve through international treaty what they have never been able to achieve through domestic political processes.

There is a need for international laws concerning the conduct of cross-border businesses. However, given the imperfections in the political processes by which they are created, and given the important role that national regulations play in promoting societal welfare, the scope of such laws should be restricted. The agreements should focus on the minimal safeguards required for conducting cross-border investments.

Countries that are under pressure to sign these agreements should be wary in doing so. Countries that have already signed these agreements should think of withdrawing, or at least demanding modifications which reduce the ambiguities and restore balance to the agreements. At the very least, they should rethink their stance.

These treaties were put in place for “instrumental” reasons—to bring more FDI—and, as such, they ought to be re-examined to see if they are doing so. Countries need to assess actual and potential risks to which these treaties expose them, assess whether they are, or are likely to have, any adverse effects in the scope of their policy space—for instance in inhibiting environmental, land use, labor, or social legislation. Are the agreements holding them up to unattainable levels of bureaucratic efficiency and competence—with risk of suit if they fail to achieve these levels? At least in some cases, the claims already brought against developing countries far outweigh the

garding housing, as does the International Covenant on Economic, Social, and Cultural Rights).

likely gains from increased investment that have resulted from such agreements.

I have suggested that the following principles might guide the future evolution of such international laws and regulations:

- a) Bilateral and multilateral agreements should focus on non-discrimination.²³⁰
- b) Compensation should be limited to actual investments, not to speculative “lost potential earnings.”
- c) Such agreements should not presume a right of establishment,²³¹ and should not go beyond domestic laws with respect to the protection of property rights. They should be particularly respectful of domestic legislation concerning the environment, labor, or affirmative action.
- d) There should be an international commercial court to adjudicate international disputes, governed by the laws of the host country.²³²
- e) In the absence of such an international commercial court, adjudication should occur in existing host country courts. If foreign corporations do not “trust” host country courts, then the adjudication should occur in the home country, but, at least when environmental damages are at the center of the dispute, at the higher of the prevailing standards of the host or home country.
- f) Those injured by corporations should be allowed to sue in host country courts, under the higher of the standards of the two countries; and there should be an agreement about cross-border enforcement of judgments.
- g) Corporate officials should be held criminally liable for the violation of domestic laws, and any BIT should provide for expedited extradition for corporate offenses.

230. In the specific sense defined in Part XI.

231. Bilateral and multilateral agreements should not provide pre-establishment rights.

232. Even when firms are domestically incorporated, suits under investment treaties can still arise, as noted.

The current rash of bilateral trade agreements may not only have direct adverse consequences on efficiency and social welfare, but the indirect consequences may be even worse. Developing countries who have been induced to sign these agreements find their democratic processes constrained: even when the vast majority of their citizens feel that some regulation is desirable they are told that they cannot adopt it; or if they do, they must pay some foreign firm large compensation.²³³ Developing countries often feel that the scope for their independent policy making is already greatly constrained, as a result of conditionalities imposed by the World Bank and the IMF. Now they face an additional set of constraints. What is the point of democracy, they ask, when the things they care about have been decided in Washington or elsewhere? When they are told their leaders signed on to such an agreement, it simply further undermines their confidence in their democratic processes. They may believe their leaders were bribed; they may believe that they were uninformed or taken advantage of; but, at the very least, they were not acting in the interests of their citizens.²³⁴

While democracy is thus undermined, so is confidence in the fairness of the international market system. The outrageous outcomes of some of the arbitration panels provide ready fuel for populists seeking to roll back market reforms.

Even the rule of law is put into question. If the rule of law is seen as a tool not for fairness and equity, but as another instrument by which the rich and powerful exploit the poor and the weak, then support for the rule of law is undermined.

MNCs have played a mixed role in our global economy: They have been responsible for many of the achievements of globalization,

233. See South African Broad-Based Black Economic Empowerment Act 53 of 2003, Bill 27-03 (GA) (S. Afr.). South Africa spent years debating—very publicly and very intensely—how far property rights should go, balancing these rights with other social objectives. The resulting national constitution represents a very delicate, and quite progressive, balance. Yet, the investment treaties which were then signed by South Africa, without any real public debate, much less parliamentary scrutiny, strike a different balance and have already put at risk important pieces of national regulation.

234. When the agreements are part of a larger trade agreement, they can be seen as a method by which the “surplus,” which the developing country might have enjoyed from the agreement, is appropriated by the developed country.

but also for some of the key problems. With the reforms described here, there is a greater chance the positive benefits will be preserved, and the adverse effects ameliorated.