

# DAMAGES IN ISDS: JUST COMPENSATION OR HIGHWAY ROBBERY?

Remarks of George Kahale, III

*in the webinar hosted by the Columbia Center on Sustainable Investment (CCSI)  
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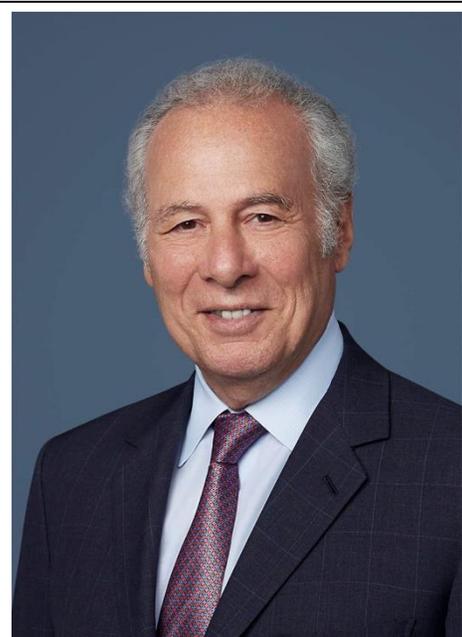
The issue of damages has become the most dangerous aspect of Investor-State Dispute Settlement (ISDS), as evidenced by the many enormous awards of recent years. CCSI organized this webinar to advance awareness of and dialogue on this issue, and explore ways of addressing it. This webinar was not recorded, but the text of George Kahale's presentation is reproduced below.

## **George Kahale III**

George Kahale is the chairman of Curtis, Mallet-Prevost, Colt & Mosle LLP. He has represented many governments and State companies in international transactions and disputes, including several of the world's largest and best known international arbitrations.

Mr. Kahale is recognized as a leading international arbitration lawyer by *Chambers*, *Legal 500* and *Global Arbitration Review*. *Legal 500* ranks Mr. Kahale in its "Hall of Fame" for international arbitration, and reports that clients describe him as "unbeatable in both commercial and investment arbitration" and "one of the very best arbitration lawyers in the world."

Mr. Kahale has written extensively on legal topics of international interest, and has appeared as a featured speaker and lecturer at various seminars and conferences around the world. He is a two-time Burton Awards winner for Distinguished Legal Writing for his 2012 article entitled "Is Investor-State Arbitration Broken?" and his 2018 article entitled "Rethinking ISDS," both of which have been the source of extensive commentary and debate. In 2014, he delivered the keynote address at the Eighth Annual Juris Investment Treaty Arbitration Conference, which received a nomination by *GAR* for best lecture of the year; in 2015, he lectured at the Arbitration Academy in Paris; in 2018, he delivered the inaugural Brooklyn Lecture on International Business Law in New York under the title "ISDS: The Wild Wild West of International Practice," as well as the widely reported keynote address at the 8th Investment Treaty Arbitration Conference in Prague, which was also nominated by *GAR* for best lecture of the year. In 2019, he was the only private practitioner invited to address the International Institute of Sustainable Development's 12<sup>th</sup> Annual Forum of Developing Country Investment Negotiators held in Bogota, Colombia.



1. First, I'd like to thank CCSI for holding this event. It seems that ISDS remains as popular a topic as ever, and I'm always pleased to share my thoughts on it from my perspective as an insider.

2. Some of you may be familiar with my general view that ISDS is a mess, a deeply flawed system that I have referred to as the "Wild, Wild West" of international law and practice. But I'm not going to speak to you today about traditional ISDS issues such as fair and equitable treatment, expropriation and most favored nation. I'm sure you've had your fill of all that. My focus today is on quantum, which of course is where the money is.

3. While the legal issues associated with jurisdiction and liability remain enormously important, quantum is what poses an immediate threat to national economies, national security, and in some cases even international peace and security. If you doubt that, just ask yourselves whether you think Russia will voluntarily pay the \$50 billion *Yukos* award if it ultimately does not succeed in setting it aside, or for that matter whether the U.S. would ever pay such an award, or even a \$10 billion award. I think you know the answer to that question if the result of our election tomorrow is four more years of Donald Trump. But I'm not sure the U.S. would be willing to cough up billions of dollars on the order of an ISDS tribunal no matter who occupies the White House.

4. What we are increasingly seeing in ISDS is not only bad decisions on basic issues of jurisdiction and liability, but also astronomical damage claims. We are truly in the age of the mega-case, where billion-dollar claims have become commonplace. These claims tend to be grossly exaggerated, and at times seem to be manufactured out of thin air, but that doesn't mean that they will not be taken seriously by an arbitral tribunal.

5. Actually, claim exaggeration is a litigation strategy that is not unique to ISDS. Some refer to it as the “anchoring” strategy, where a claimant opens with an absurdly high damage claim to condition the tribunal and pave the way for fallback positions that are still preposterous but appear more reasonable when compared to the initial, even more preposterous damage figure. It’s a little like a store doubling its prices and then offering a 25% discount. Don’t assume for a moment that this strategy can never work, particularly in ISDS, where it has been elevated to an art form. In a system where virtually anything goes in terms of evidence, where tribunals consist of lawyers who often are unfamiliar or uncomfortable with quantum issues, and where some of those lawyers think their job is to advance their appointing party’s interests or their own ideology rather than to apply the law, these kinds of mistakes can be, and too often are made. And with so much at stake, the mistakes are costly. We are not only talking about academic issues here; we’re talking about a system that is out of control and very dangerous.

6. I’m going to highlight just two issues relating to quantum, which are largely responsible for the proliferation of these mega claims: (1) the use of what is called the discounted cash flow methodology of valuation (known as DCF); and (2) the importance of selecting an appropriate discount rate.

7. Let’s start with the use of DCF. Its object is to arrive at the present value of a cash flow generated by an asset or a business. The fundamental problem with DCF is that it creates the illusion of precision when it is in fact inherently imprecise. A DCF analysis is based on projections of cash flows over a period of years, which could be 10, 20, 30 years or more. You have to build an economic model that incorporates assumptions for each element of cost and each element of revenues, any one of which can have a material impact on the overall result.

8. For example, in an oil project, even assuming that we're talking about a case in which oil has already been discovered, it is necessary to project development expenditures, the time to achieve first oil, the number of wells required and the cost per well, the cost of other infrastructure that may be required to bring the oil to market, the inflation rate, the panoply of taxes and royalties that may be payable, the rates of production and production decline of the field over the life of the project, and of course oil prices.

9. The only thing one can be certain about with these projections is that they will all be wrong, and sometimes spectacularly so. Let's take just one simple example, continuing with the oil analogy. Projecting the price of oil over a period of even one year is a risky proposition; predicting it over a period of 20 years is an exercise in fantasy. In the entire decade of the 1990s, the price of oil averaged around \$18 per barrel. You couldn't find a lot of experts predicting \$100 oil at that time. But by July 2008, oil reached a high of close to \$150 per barrel, only to plummet to \$35 in December of that same year. In 2011, the price again climbed to over \$100 until late in 2014, when it plummeted again. Obviously, if you value your project in a \$100 per barrel environment, you're going to get a radically different result than if you value it using a price of \$30.

10. On the cost side, we have seen cases in which the costs were so wildly out of control as to make a mockery out of all previous valuations. According to one study a few years back, a large majority of projects in the oil industry were well over budget, significantly delayed, or both.<sup>1</sup> The development of one of the world's largest discoveries ever took around a decade longer than expected and was tens of billions of dollars over budget. Not all projects have problems of that magnitude, but as I said, you're not going to find any accurate projections of cash flows over a 10, 20 or 30-year period; no one has that kind of crystal ball. And if it takes twice as long as projected to reach first oil

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<sup>1</sup> Ernst & Young, *Spotlight on Oil and Gas Megaprojects*, OIL AND GAS CAPITAL PROJECT SERIES, 2014.

and costs twice as much, the net present value of the project is likely to be wiped out, even assuming that the revenue projections are 100% accurate, which is never the case.

11. These uncertainties are why DCF is by nature highly susceptible to abuse. One experienced commentator described it a couple of decades ago as a method “tainted by misapplication” that “has been used to justify valuations which reach beyond the ‘fanciful’ to ‘wonderland proportions’.”<sup>2</sup> If you have any experience in these arbitrations, you can appreciate just how apt that description is.

12. In issuing its 1992 Guidelines on the Treatment of Foreign Direct Investment, the World Bank warned that “particular caution should be observed in applying [DCF], as experience shows that investors tend to greatly exaggerate their claims of compensation for lost future profits.” Yet in case after case, what we see is claimants taking abuse of DCF to greater and greater heights. They do this with the help of experts who give the damage claims a veneer of credibility, even though the results of their analyses are often surrealistic.

13. The World Bank Guidelines state that DCF should not be applied absent “a going concern with a proven record of profitability.” That in turn is defined as “an enterprise consisting of income-producing assets which has been in operation for a sufficient period of time to generate the data required for the calculation of future income. . . .”

14. There is a long line of cases going back 30 years to the same effect, but that hasn’t stopped claimants from trying to establish the principle that DCF can and should be used even in the absence of a track record of profitability. You’d be amazed at how some experts have twisted the definition of “going concern” to include virtually any company, regardless of whether it is even close

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<sup>2</sup> Thomas Stauffer, *Valuation of Assets in International Takings*, 17(2) Energy Law Journal 459 (1996), p. 479.

to having a real business. For some, it seems that an off-the-shelf company with a small office, or perhaps today a virtual office, a laptop, and a business plan written on the back of an envelope consisting of little more than a hope and a prayer is sufficient.

15. If you think applying DCF to value businesses that never got off the ground is not dangerous, take a look at what happened in the *Al-Kharafi* case involving Libya, the *P&ID* case involving Nigeria, and the *Tethyan* case involving Pakistan.

16. In *Al-Kharafi*, the tribunal awarded almost \$1 billion in damages for a tourism project in Libya that not only was never built, but it was also a project in which the investor had invested almost nothing and apparently was initially seeking a settlement of \$5 million. A court in Cairo, which was the seat of the arbitration, recently decided after years of litigation that the award should be set aside, basically on the ground that it bore no relationship to reality, but there are still enforcement proceedings going on in Europe.

17. In *P&ID vs. Nigeria*, at issue was a gas processing project in which the facility again was never built. Construction hadn't even begun, but the tribunal awarded around \$6.6 billion, which with interest is now around \$10 billion. The award is being challenged on various grounds, but just on the issue of quantum, it was nothing short of shocking. By the way, while it's not the focus of our discussion today, you might be interested to know that recently a Court in London allowed Nigeria to file an application to set the award aside even though the normal time to file had expired. The court did that because it said that there is a strong *prima facie* case that the underlying agreement had been procured by bribery, a strong *prima facie* case that the claimant's founder had given perjured evidence to the tribunal, a *prima facie* case that the arbitration proceedings were tainted by the conduct of Nigeria's advocate, and a strong *prima facie* case of fraud which claimant had covered up.

18. The *Tethyan* case involved a mining project in Pakistan, which was also not in production. Yet again the tribunal applied DCF to come up with a damage award of over \$4 billion, and that's before adding interest, which now brings it to over \$6 billion. As if that weren't enough, Pakistan was ordered to pay claimant's costs of the case, which believe it or not were around \$60 million – that's just the costs of the case, not the compensation award. With awards like that, you have to wonder whether executives running these ventures spend half their time thinking about how to get expropriated, and hoping that they do. It's an interesting new business model: "Please expropriate me so I can finally make some money in arbitration!"

19. In another case that is not yet public, the tribunal decided to apply DCF to value a start-up that not only had no track record of profitability, but it also lacked the essential licenses for the business it wanted to roll out. The company had no revenues, no customers, and did not even project positive cash flows for many years. The degree of speculation surrounding each key assumption in the economic model was high, and the model was highly sensitive to even slight variations in assumptions. The very idea of using DCF under those circumstances is difficult to fathom. Yet by a two-to-one majority, somehow the tribunal thought that using DCF was appropriate. That is the direction in which advocates of ISDS are pushing the system. Frankly, it's the kind of thing that gives ISDS a bad name.

20. Now for the second issue: discount rate. How is it possible for these tribunals to come up with such astronomical damage awards? The answer lies not only in the fact that DCF is used, but in large part also in the discount rate that is applied to bring the cash flows back to the present. The lower the discount rate, the higher the net present value. Much of the argument on quantum in these cases revolves around selecting the discount rate, which claimants typically argue, again with the support of experts, should not be far from the risk-free rate, downplaying the project risks and either

ignoring or underestimating the concept of country risk or political risk. Depending on how this issue is argued and the composition of the tribunal deciding it, the results can vary greatly.

21. For example, the tribunal in an ICSID case brought by Occidental against Ecuador applied a discount rate of 12%. Not long after that, another ICSID tribunal in the case brought by ExxonMobil subsidiaries against Venezuela applied an 18% discount rate. That was at a time when there was no logical basis for applying a lower rate for an oil project in Ecuador than there was for one in Venezuela. If even the 18% rate had been applied in *Occidental* instead of 12%, the \$1.8 billion award undoubtedly would have been far more manageable and palatable to Ecuador.

22. Similarly, in the *Gold Reserve* case, the tribunal largely accepted the arguments of the claimant and applied a 10% discount rate for a mining project in Venezuela, whereas in the *Tidewater* case, in which the claimant used the very same expert who testified in *Gold Reserve*, a 26% discount rate was applied for a business in the same country. Obviously, if the 26% rate had been applied in *Gold Reserve*, the \$700 million-plus award would have been far lower.

23. Even more shocking is the *P&ID* award against Nigeria that I mentioned earlier. In that case, the tribunal applied a 2.65% discount rate – essentially the risk-free rate. If DCF were to be used at all for that project – and remember, it was never even built – one might have expected a discount rate many times higher to be used. A different tribunal might easily have come to the conclusion that a discount rate of at least 20% – not 2.65% – would have been more appropriate, which presumably would have lowered the award by billions, not just hundreds of millions, but billions of dollars.

24. The same can be said of the more recent *Tethyan* case. That's the other multibillion-dollar award I mentioned earlier that was based on a project in Pakistan that hadn't produced a thing. In *Tethyan*, the tribunal accepted what was called the "modern DCF" method, a new method of

supposedly incorporating all project risks into the cash flows and therefore allowing the use of the risk-free rate, or the U.S. Treasury rate, as the discount rate. If anything like a normal discount rate for such a project had been applied, it is not clear that the project would have had any value.

25. By the way, it is interesting to note that the arbitrator appointed by Pakistan in the *Tethyan* case was the presiding arbitrator in the *P&ID* case, which goes to show you how careful you need to be in selecting an arbitrator, and how the composition of the tribunal is often itself outcome-determinative – this is one of the main distinctions between ISDS and a mature and serious legal system.

26. I will conclude my remarks with a warning, and that is that the danger created by ISDS is real, and its most dangerous aspect is quantum. The term “highway robbery” may be a bit harsh, but the reality is that too many costly mistakes have been made, and the system does not have sufficient checks and balances to correct them.

27. The additional bad news is that I’m not convinced the highly publicized efforts at reform in UNCITRAL Working Group III will yield constructive results. What is to be expected from a working group whose mandate does not include substance? I understand that there is a movement to address quantum in the Working Group, but it’s not clear to me how that can meaningfully be done, given the limited mandate. What is clear is that, predictably, many of the participants in the Working Group are growing increasingly frustrated at the lack of attention to substance, and with good reason.

28. As you know, there is a lot of talk about building the infrastructure of a legal system within ISDS, such as appellate tribunals or a standing international investment tribunal. If the well-intentioned reformers happen to achieve success in their endeavors and a variety of appellate mechanisms or permanent courts are created, I worry about the legal principles they would be expected

to apply, and who would be the persons applying them? The libraries are now full of decisions on basic principles of public international law that in the past would not have passed muster in any serious law school classroom. Are these the precedents that we want to use as the starting point in the new, reformed ISDS? These and many other difficult questions come to mind when thinking about this reform process. But mostly, I wonder whether the entire focus of the reform is misplaced.

29. As I have previously said, my approach to reform would be different. I would start from the premise that procedural reforms will not fix a broken system. Worse, they run the risk of giving what ISDS has become the stamp of approval that it does not deserve. The first guiding principle of reform should be “Do No Harm.” That’s why I have long thought that the better approach would be to dismantle the existing infrastructure of ISDS by amending and terminating treaties, including their arbitration and sunset clauses, and rebuilding from scratch.

30. In the meantime, I think that those who are dissatisfied with the existing system – and that’s a club whose membership eventually should include virtually all states – would be well served to focus on the substantive issues and develop a set of principles that all, or at least a large majority of states, can adhere to. I don’t mean drafting a comprehensive model investment treaty. There is no need to hold up basic agreement on individual principles that come up in case after case, while haggling over the details of a full treaty that is unlikely to ever be agreed and may not even be desirable. It shouldn’t be that difficult for states to agree, for example, that the concept of legitimate expectations is not part of the minimum standard of treatment under customary international law. After all, virtually every state takes that position when defending claims in arbitration. Why not announce that position publicly before the claims come? Similarly, what state would not agree that the approach on damages taken by the *Al-Kharafi*, *P&ID* and *Tethyan* tribunals is fundamentally flawed? I suspect none. Yet the silence on these issues cedes the ground to those who are constantly pushing

the envelope in ISDS. As I've said before, breaking new ground in ISDS normally means expanding investor protection at the expense of states and at the expense of the coherent development of the law, so there is a steep price to be paid for the failure to progress on substance.

31. More and more states are coming to appreciate this point, as is evident from the fact that it is no longer just the capital importing countries that are complaining. In fact, the loudest cries for reform are now coming from Europe. Why? Because the European countries over the last few years have been among the leading victims of the system they once championed. With this growing consensus that ISDS is a broken system, one would think that change is in the air. It is, but I'm just not sure the wind is blowing in the right direction.

That brings me to the end of my remarks. I thank you for your attention.