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The Efficient Breach Theory in International Investment Law

Sangwani Patrick Ng'ambi[*]

Abstract

When a State unilaterally abrogates its contractual obligations, it is under a duty to compensate the investor. The aim of the compensation regime under International Investment Law is to restore the investor to a position he or she would have been in had the breach not taken place. Thus, the award of compensation should not only include sunk costs (damnum emergens) but also lost future profits (lucrum cessans).

In this article it is argued that the rules relating to compensation promote efficiency, as per the 'efficient breach theory' because they dissuade governments from unilaterally abrogating concession agreements, unless they can compensate the investor, including lost future profits, whilst making some money on top of that. However, the limitation of the efficient breach theory is that it presupposes that wealth maximization is the paramount consideration for all parties involved in a contract. This article shows that this is not necessarily the case with States.

Typically, host States cite socio-economic reasons for their termination, rather than profit maximization. This can be contrasted with commercial actors whose only concern is making money. Thus, while the International Investment Law certainly encourages efficiency, it does not provide host States with sufficient flexibility to pursue its legitimate public objectives, when it breaches agreements.

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1.0 INTRODUCTION

Under international law, host States have an obligation to compensate an investor when the former prematurely terminates a concession agreement with the latter.[1] However, the basis upon which compensation is to be assessed remains controversial.[2] This is further compounded by the fact that there is no clear position as to which standard of compensation is applicable under international investment law.[3] There are two standards of compensation under international law. These are: appropriate compensation and the 'Hull Principle.'[4]

The appropriate compensation standard espouses that any compensation payable to the investor should be determined on a case-by-case basis, taking into account all the relevant circumstances.[5] This can be contrasted with the Hull Principle, which espouses that compensation must be prompt, adequate, and effective.[6] The term adequate entails that the host State must restore the investor to the position that he or she would have been in had the termination not taken place. As such, the compensation package must not only include sunk costs (*damnum emergens*) but also lost future profits (*lucrum cessans*). Lost future profits are typically calculated through the application of the discounted cash flow (DCF) method. This involves deducting future expenditures from the gross receipts of the enterprise. Issues of inflation are also taken into account.[7]

The DCF method is also applied by arbitral tribunals, who explicitly adopt the appropriate compensation standard.[8] This is advantageous because it restores the investor to a position that he or she would have been

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1 *See* IRMGARD MARBOE, CALCULATION OF COMPENSATION AND DAMAGES IN INTERNATIONAL INVESTMENT LAW 32 (2d ed. 2017); JESWALD W. SALACUSE, THE THREE LAWS OF INTERNATIONAL INVESTMENT: NATIONAL, CONTRACTUAL, AND INTERNATIONAL FRAMEWORKS FOR FOREIGN CAPITAL 314-15 (2013).

2 IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 514 (6th ed. 2003).

3 SURYA SUBEDI, INTERNATIONAL INVESTMENT LAW: RECONCILING POLICY AND PRINCIPLE 124 (4th ed. 2020) ("For instance, there is a requirement in international law to pay compensation against expropriation. However, international law does not spell out every detail as to the method of arriving at an amount to be paid and how and when it is to be paid. Even the 'prompt, adequate and effective' compensation formula is not universally accepted.").

4 SANGWANI PATRICK NG'AMBI & KANGWA-MUSOLE GEORGE CHISANGA, INTERNATIONAL INVESTMENT LAW AND GENDER EQUALITY: STABILIZATION CLAUSES AND FOREIGN INVESTMENT 79 (2020).

5 Eduardo Jiménez de Aréchaga, *State Responsibility for the Nationalization of Foreign Owned Property*, 11 N.Y.U. J. INT'L L. & POL. 179, 188-89 (1978).

6 *See* Tippets, Abbett, McCarthy, Stratton v. TAMS AFFA, 6 Iran –U.S. C.T.R. 219, 225 (1984). *See also* JUNJI NAKAGAWA, NATIONALIZATION, NATURAL RESOURCES AND INTERNATIONAL INVESTMENT LAW: CONTRACTUAL RELATIONSHIP AS A DYNAMIC BARGAINING PROCESS 128 (2018).

7 Seymour J. Rubin, Guideline IV(6), *World Bank Guidelines, on the Treatment of Foreign Direct Investment*, 31 I.L.M. 1363, 1383 (1992) [hereinafter *Guidelines*].

8 *See* Aminoil v. Kuwait, 21 I.L.M. 976, 1033, para. 144 (1982).

in had the unilateral termination of the concession agreement not taken place.[9] Furthermore, the State only has an incentive to terminate a concession in the event that it stands to make a profit, even after indemnifying the foreign investor. In this sense, the rules pertaining to compensation under international investment law promote efficiency because no party loses out and one party, the State, makes a gain.

The rules pertaining to international investment law, as they do under national law, certainly promote efficiency by giving the parties under the contract an incentive to perform unless doing so would be inefficient.[10] This is the very essence of the efficient breach theory in contract law. One of the pillars of this theory is that the main goals of the parties to a contract are to make a profit and maximize wealth. As such, the interests and objectives of the parties can fully be translated into monetary terms.

Despite the fact that the rules under international investment law promote efficiency, there is a limitation to the application of the efficient breach theory to concession agreements. This is owing to the fact that one of the parties to the concession is the State, whose goals cannot solely be quantified in monetary terms. When a State nationalizes or expropriates, for example, this is invariably for a public purpose.[11] This public purpose would entail the reorganization of the State's socio-economic policies. Therefore, wealth maximization is not the paramount concern for the State. This article argues that although the existing standards of compensation promote efficiency, they do not provide sufficient flexibility for governments whose objectives are often at variance with those of the foreign investor.

Part Two of this article will examine the compensation standards under international investment law. Part Three will examine the efficient breach theory and its application under international investment law. Part Four will consist of a conclusion.

2.0 STANDARDS OF COMPENSATION IN INTERNATIONAL INVESTMENT LAW

When the host State nationalizes property belonging to a foreign investor, it has a duty to pay compensation.[12] As was stated by the arbitral

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9 *See* Concerning Certain German Interests in Polish Upper Silesia, 1925 P.C.I.J. (ser. A) No. 6 (Aug. 25) (the "Chorzow factory case") [hereinafter German Interests].

10 Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 N.Y.U. L.R. 1679, 1680 (2008). *See also* ERIC A. POSNER & ALAN O. SYKES, ECONOMIC FOUNDATIONS OF INTERNATIONAL LAW 25 (2013).

11 ANDREAS F. LOWENFELD, INTERNATIONAL ECONOMIC LAW 564 (2d ed. 2008).

12 *See* Muna Ndulo, *The Nationalization of the Zambian Copper Industry*, 6 ZAM. L.J. 55, 65 (1974); Paolo Vargiu, *Environmental Expropriation in International Investment Law*, *in* FOREIGN INVESTMENT AND COMMON CONCERNS: AN INTERNATIONAL LAW PERSPECTIVE 213 (Tullio Treves, Francesco Seatzu, & Seline Trevisanut eds., 2014); David Khachvani, *Unlawful Expropriation: Targeting the Illegality*, 32 ICSID REV. 385 (2017).

tribunal in the *Upton Case*,[13] States have the unquestionable right to "appropriate private property for public purpose."[14] However, there is a duty to compensate the owner.[15] The classical purpose behind compensation is to eliminate all the consequences of the State's action. This means restoring the investor to a position that he or she would have been in had the State not unilaterally abrogated the agreement.[16]

There are two standards of compensation under international investment law. The first is the 'Hull Principle,' which requires that compensation payable must be 'prompt, adequate and effective.' Of importance is the term 'adequate.' The adequacy of compensation is contingent upon compensating the investor for the full market value of the nationalized assets and also for lost future profits (*lucrum cessans*).[17] The other standard only requires the host State pay 'appropriate compensation.' This is determined on a case-by-case basis. The first part of this section will examine the Hull Principle. The second part will discuss the appropriate compensation standard before discussing lost future profits in the third part.

2.1 The Hull Principle

The Hull Principle is very specific in that it espouses a formula for compensation. Under this principle, compensation must be "prompt, adequate and effective."[18] According to this principle, the term "adequate" means that the nationalizing State should restore the investor to the same position that the latter would have been in, had the nationalization not occurred. Thus, the compensation package must include the market value of the enterprise and lost future profits.[19] The term 'prompt' means that the payment must be made within a 'reasonable time'[20] and there should be no inordinate delays.[21] Furthermore, the interest rate payable should be such that it does not have an adverse effect on the adequacy of the compensation.[22] 'Effective' means that the currency should be made in a freely convertible currency. Moreover, there should be no restriction on its

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13 *Upton Case*, Ven. Arb., 172 (1903).

14 *Id*. at 173.

15 *Id.*

16 Aréchaga, *supra* note 5, at 180.

17 *See* AGIP Company v. Popular Republic of the Congo, 21 I.L.M. 726 (1982); Richard J. Smith, *The United States Government Perspective on Expropriation and Investment in Developing Countries*, 9 VAND. J. TRANSNAT'L L. 517, 519 (1976).

18 GREEN HACKWORTH, 3 DIGEST OF INTERNATIONAL LAW, 660-65 (1942).

19 Smith, *supra* note 17, at 519.

20 RESTATEMENT OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES §712 cmt. g (AM. LAW. INST., Tentative Draft No. 3, 1982).

21 Pamela B. Gann, *Compensation Standard for Expropriation*, 23 COLUM. J. TRANSNAT'L L. 615, 620 (1985).

22 *Id.*

repatriation.[23]

In later years, the State Department of the United States developed further guidelines on the term 'adequate.'[24] In its view, when American owned property is expropriated, the owner must be paid full market value for its assets. Fair market value is to be calculated as if the expropriation had not occurred. The State Department acknowledged that market value is not always ascertainable because there might have been no recent sales of comparable property.[25] Given this fact, the State Department utilizes three indirect valuation methods in order to determine market value.[26] These are the going concern approach, the replacement cost approach, and the book value approach.[27]

Under the 'going concern' approach, estimations of market value are based on the earning power of the company.[28] This includes considering the loss of future profits, which are typically based on past earnings or estimates of future earnings. The State Department recognized that it will not always be possible to apply this method because doing so might be impractical or unfair, especially in instances where the investment has not been operating long and therefore has a limited profit history.[29] The State Department also recognized that this method is susceptible to government manipulations, that may distort the profitability of the operations.[30] This includes, "increased taxes, threat of cancellation of contractual or concessionary rights, or withdrawals of privileges."[31]

Some tribunals have been rather cautious about awarding lost future profits because they can be speculative. This was certainly the position taken in the separate opinion of Professor Brownlie in the case of *CME v. Czech Republic*.[32] He contended that compensation must be both just and reflect the genuine value of the investments affected.[33] The genuine value of the investment must be compatible with a reasonable rate of return. [34] Thus, in his separate opinion, Professor Brownlie awarded a sum of $160.9 million. By his own admission, this was significantly lower than that

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23 RESTATEMENT OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES, *supra* note 20.

24 Smith, *supra* note 17, at 519-520.

25 *Id.* at 520.

26 *Id.*

27 *Id.*

28 *Id.; see also* JAMES CRAWFORD, THE INTERNATIONAL LAW COMMISSION'S ARTICLES ON STATE RESPONSIBILITY, INTRODUCTION, TEXT AND COMMENTARIES 226 (2002).

29 Smith, *supra* note 17, at 520.

30 *Id.*

31 *Id.* at 519.

32 *CME Czech Republic B.V. (Netherlands) v. Czech Republic*, 69, (UNCITRAL Arb. Trib. Mar. 14, 2003).

33 *Id*. at 106.

34 *Id*. at 115.

rendered in the Final Award.[35] This is evidence that even in a tribunal there can be disagreement as to how to quantify loss to the investor.

Under the 'replacement cost' approach, the party determining the amount of compensation payable should look at the cost of replacing the property at the time of the expropriation "less actual depreciation."[36] Although this amount is greater than book value, it does not take into account the earning power of the entity, which is determined through looking at projected future profits. The State Department considered this approach "generally less acceptable in most circumstances than the going-concern approach."[37] It is further noted that this method is rarely applicable in instances of government takings and can only be used where replacement costs are identical to taken assets. This is rarely the case when assets are taken by the State. Moreover, because the investor's assets are typically very unique, estimating the value of replacement is impossible.[38]

The 'book value' approach involves valuing assets at the "acquisition cost less depreciation . . . ."[39] The State Department says that the value under this approach "bears little relationship to [the] actual value."[40] This was illustrated in the case of *Asian Agricultural Ltd v. Republic of Sri Lanka*.[41] In this case, the State had a duty to provide full protection and security to the investment in question. Due to the State's failure to do so, armed insurgents destroyed a shrimp farm, in which the investor had a 48 per cent shareholding interest. The Tribunal refused to order the State to pay for lost profits in this case. This is because the purchaser would have been rather sceptical about whether future earnings could sufficiently offset past losses. Furthermore, the loans the company had taken out exceeded the company's assets.[42]

Since the investor could not be compensated for any future profits, the arbitral tribunal drew up a comprehensive balance sheet.[43] This comprehensive balance sheet was a reflection of the investor's assets and liabilities, which was derived from a list of the company's tangible assets.[44]

The book value approach disregards various factors such as the "enterprises' contractual rights, know-how, goodwill, and management skills."[45] It also merely measures what is on the company's balance sheet.

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35 *Id*. at 121. The tribunal itself rendered an award of US $270 million. *Id.* at ¶ 649.

36 Smith, *supra* note 17, at 519.

37 *Id.*

38 CAMPBELL MCLACHLAN, LAURENCE SHORE & MATTHEW WEINIGER, INTERNATIONAL INVESTMENT ARBITRATION: SUBSTANTIVE PRINCIPLES 319 (1st ed. 2007).

39 Smith, *supra* note 17, at 520.

40 *Id.*

41 ICSID Case No. ARB/87/3 (1990), 30 I.L.M. 577 (1991).

42 *Id.* at ¶ 103.

43 *Id.* at ¶ 98.

44 *Id.*

45 MCLACHLAN, SHORE & WEINIGER *supra* note 38, at 319.

This is usually determined by applying standard accounting principles.[46] Therefore, it comes as no surprise that the State Department considers this the least acceptable method of valuation.[47]

In determining the applicable method of valuation, all the circumstances of the case must be considered. In this way, the individual determining compensation payable may apply one method or a combination of them in arriving at a figure that will justly compensate the investor. The State Department further recognizes that compensation can also come in non-monetary forms, including as goods, kickbacks, and other services.[48]

2.2 Appropriate Compensation

Under the appropriate compensation standard, the amount payable to the investor should be determined on a case by case basis.[49] In sharp contrast to the Hull Principle, the appropriate compensation standard requires no precise definition.[50] Not having a precise definition is beneficial because it provides a flexible standard which can accommodate all the prevailing circumstances when determining the amount of compensation payable to the investor.[51] The appropriate compensation standard has been endorsed by the United Nations General Assembly, the European Court of Human Rights, the House of Lords and the United States Court of Appeals (Second Circuit).[52]

The appropriate compensation standard was endorsed by the United Nations General Assembly in Resolution 1803 (1962). This General Assembly Resolution is particularly notable, because it was endorsed by both developed and developing nations, although in this instance the United States believed the term 'appropriate' meant 'prompt, adequate, and effective' to be in line with the Hull Formula.[53] General Assembly Resolution 1803 states that:

> 4. Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest

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[46] *Id*. at 321. *See also* Paul D. Friedland & Eleanor Wong, *Measuring Damages for the Deprivation of Income-Producing Assets: ICSID Case Studies*, 6 ICSID REV. FOREIGN INV. L. J. 400, 404-05 (1991).

[47] Smith, *supra* note 17, at 519.

[48] *Id.* at 520.

[49] Ebrahimi v. Iran 30 Iran-U.S. Cl. Trib. Rep. 174, ¶¶ 88, 95 (1994); *see also* Aréchaga, *supra* note 5, at 185.

[50] Rudolf Dolzer, *Expropriation and Nationalization, in* 8 ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW 214, 218-19 (1985); Andra Eisenberg, *Different Constitutional Formulations of Compensation Clauses*, 9 S. AFR. J. ON HUM. RTS. 412, 418 (1993).

[51] M Sornarajah, *Compensation for Expropriation. The Emergence of New Standards*, 13 J. WORLD TRADE L. 108, 127-28 (1979).

[52] *See* Eisenberg, *supra* note 50, at 416-20.

[53] *See* Stephen M. Schwebel, *The Story of the U.N.'s Declaration on Permanent Sovereignty over Natural Resources*, 49 A.B.A. J. 463, 465 (1963).

> which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases, the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law.[54]

The General Assembly took a similar position in the Charter on the Economic Rights and Duties of States (CERDS).[55] It recognized the right of States to nationalize foreign property, provided that appropriate compensation is paid by the host State "taking into account its relevant laws and regulations and all circumstances that the State considers pertinent."[56] It further states that in the event where the issue of compensation leads to controversy, the matter must be settled under the national laws and tribunals of the host State unless it is otherwise agreed.[57]

In *Lithgow v. United Kingdom*,[58] the European Court of Human Rights held that the right to nationalize was linked to the right of a State to determine the amount of compensation payable to the individual. The State is in the best place to make such a determination because it has a wider knowledge "of their society and its needs and resources . . . ."[59] Given this fact, the State is better placed to determine what measures it ought to take. The European Court of Human Rights could not divorce the United Kingdom's determination of compensation from its actual decision to nationalize "since the factors influencing the latter will of necessity also influence the former."[60] For this reason, the European Court of Human Rights refused to question the legislature's judgment, unless there were reasonable grounds to do so.[61]

In the case of *Williams & Humbert Ltd. v. W. & H. Trademarks*, the House of Lords considered the question of compensation when the Spanish government nationalized property belonging to an English family.[62] The House of Lords endorsed the appropriate compensation standard. Lord Templeman opined that it was a firmly established principle that the host State has the right to nationalize property. Compensation had to be determined in light of the State's right to nationalize.[63]

The American case of *Banco Nacional de Cuba v. Chase Manhattan*

54 General Assembly Resolution 1803 (XVII) of 1962; *see also* General Assembly Resolution 2158 (XXI) of 1966.

55 General Assembly Resolution 3281 (XXIX) of 1974.

56 *Id.*

57 *Id.*

58 8 Eur. H.R. Rep. 329 (1986).

59 *Id.* at 373.

60 *Id.*

61 *Id.*

62 [1986] 1 AC 368 (Eng.).

63 *Id.* at ¶¶ 430-441.

Bank[64] arose out of the Cuban nationalizations. The United States Court of Appeals (Second Circuit), in this case, held that failure to pay compensation after nationalizing private assets is a violation of international law.[65] The Court of Appeals (Second Circuit) contended that the standard applicable would have been appropriate compensation. However, the court also held that 'appropriate' could also mean 'full compensation.' The Court of Appeal thus contended that:

> It may well be the consensus of nations that full compensation need not be paid "in all circumstances," . . . and that requiring an expropriating state to pay "appropriate compensation," even considering the lack of precise definition of that term, would come closest to reflecting what international law requires. But the adoption of an "appropriate compensation" requirement would not exclude the possibility that in some cases full compensation would be appropriate.[66]

The World Bank Guidelines on the Treatment of Foreign Direct Investment echo the sentiments espoused in the *Banco Nacional* case and endorse the 'appropriate compensation' standard. However, they also state that compensation is only appropriate if it is 'adequate, effective and prompt.'[67]

It is clear from the foregoing that no consensus exists on which standard of compensation applies in international investment law.[68] It would appear that the Hull Principle is not universally accepted.[69] However, it has been adopted in most, although not all, Bilateral Investment Treaties.[70] Although arbitral tribunals do not explicitly endorse the Hull Principle, they do recognize its foundational principles. This is reflected in the fact that arbitral tribunals invariably recognize that lost future profits should be included in the award of compensation. As such, even though appropriate compensation might be the standard applied, the effect of arbitral decisions reflects a standard of compensation that resembles the

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64 Banco Nacional de Cuba v. Chase Manhattan Bank, 658 F.2d 875 (2d Cir. 1981).

65 *Id.*

66 *Id.* at 892.

67 *See also* Guideline IV(1) & IV(2), *Guidelines*, *supra* note 7, at 1382.

68 Rudolph Dolzer, *New Foundations of the Law of Expropriation of Alien Property*, 75 AM. J. INT'L L. 553, 553 (1981).

69 *See* Oscar Schachter, *Compensation for Expropriation*, 78 AM. J. INT'L L., 121 (1984); Frank G. Dawson & Burns H. Weston, *Prompt, Adequate and Effective: A Universal Standard of Compensation?*, 30 FORDHAM L. REV. 727 (1962).

70 Lowenfeld, *supra* note 11, at 564; MCLACHLAN, SHORE & WEINIGER *supra* note 38, at 317; Wenhua Shan, *Is Calvo Dead?*, 55 AM. J. COMP. L. 123 (2007). *See also* Wenhua Shan & Norah Gallagher, *China*, *in* COMMENTARIES ON SELECTED MODEL INVESTMENT TREATIES 131, 164-65 (Chester Brown ed., 2013) (discussing the Chinese Model BIT. Even though it avoids language such as 'adequate' as per the Hull Formula, the actual calculation methods prescribed are not substantially different the aforementioned standard of compensation.).

Hull Principle.[71]

2.3 Lost Future Profits

The case law examined in this section demonstrates that the State is under an obligation to compensate the investor for lost future profits in the event that it prematurely terminates a concession. Loss of future profits have oftentimes been part of the criteria used in determining the fair market value of the property when it was taken.[72] Some writers argue that loss of future profits should only be included in the compensation package when the taking is deemed to be illegal.[73] However, this subsection demonstrates that lost future profits are awarded even where the taking is deemed to be legal.[74] Thus, arbitral tribunals make no distinction between legal and illegal takings. This is because the rationale behind paying compensation is to restore the investor to the same pecuniary position they would have been in had the nationalization not taken place.[75] As observed by the tribunal in *Sapphire International Petroleum Ltd. v. National Iranian Oil Co. (NIOC)*:[76]

> This rule is simply a direct deduction from the principle *pacta sunt servanda*, since its only effect is to substitute a pecuniary obligation for the obligation which was promised but not performed. It is therefore natural that the creditor should thereby be given full compensation. This compensation includes loss suffered (*damnum emergens*), for example expenses incurred in performing the contract, and the profit lost (*lucrum cessans*), for example the net profit which the contract would have produced. The award of compensation for the lost profit or the loss of a possible benefit has been frequently allowed by international tribunals.[77]

From the foregoing, it can be seen that the State has two obligations: to either perform its obligations under the contract or to compensate the

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71 M.H. Mendelson, *Compensation for Expropriation: The Case Law*, 79 AM. J. INT'L L. 414, 415 (1985).

72 Phillips Petroleum Co. Iran v. Islamic Republic of Iran, 21 Iran-U.S. Cl. Trib. Rep. 79, 123 (1989).

73 Derek W. Bowett, *State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach*, 59 BRIT. Y.B. INT'L L. 49, 63 (1988). *See also* IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW, 539 (7th ed. 2008); Irmgard Marboe, *Compensation and Damages in International Law—The Limits of Fair Market Value*, 7 J. WORLD INV. & TRADE 723 (2006).

74 *See* CRAWFORD, *supra* note 28, at 226; William C. Lieblich, *Determinations by International Tribunals of the Economic Value of Expropriated Enterprises*, 7 J. INT'L ARB. 37, 47-48 (1990).

75 Sapphire Int'l Petroleum Ltd. v. Nat'l Iranian Oil Co. (NIOC), 35 I.L.R. 136, 185-86 (1963).

76 *Id.*

77 *Id.*

investor. This package includes loss suffered and lost future net profits. An early case in which lost future profits were awarded is the *Case Concerning German Interests in Upper Silesia*.[78] In this case, the Permanent Court of International Justice awarded lost future profits because the host State had unilaterally abrogated its treaty obligations. In this case, the Polish government had taken over a company in which German companies had rights. This was specifically prohibited by Article 6 of the Geneva Convention Concerning Upper Silesia. Article 6 thus provided that the whilst the Polish government had a general right to nationalize, the right did not extend to property belonging to German nationals.[79] The German government thus sued Poland for compensation.

The Permanent Court of International Justice held that in the event where a government breaches an undertaking, there is general obligation to make reparations. [80] In their view, such reparations, "must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed."[81] They contended that this included the award of lost future profits.[82]

The International Court of Arbitration took a similar approach in the case of *Lena Goldfield v. USSR*.[83] In assessing damages, the arbitral tribunal contended that the Soviet Union had unjustly enriched itself, through the repudiation of their agreement.[84] Thus, Lena Goldfields was awarded a sum of £13 million. Implicitly included within this figure was lost future profits because Lena Goldfields had only invested an initial sum of $20 million.[85]

Lost future profits are determined by determining future gross earnings of a company and deducting future liabilities. This is called the discounted cash flow (DCF) method. This approach was certainly taken by the arbitral tribunal in the case of *LIAMCO v. Libya*.[86] The arbitral tribunal did acknowledge that Libya had the sovereign right to prematurely terminate its agreement with LIAMCO. Although the premature termination was deemed legal, it did constitute a 'source of liability to compensate the

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78 German Interests, *supra* note 9.

79 *Id.* at 21.

80 *Id.* at 29.

81 *Id.*

82 *Id.* at 52.

83 Arthur Nussbaum, *The Arbitration between the Lena Goldfields, Ltd. and the Soviet Government*, 36 CORNELL L.Q. 31, 42 (1950-51).

84 *Id.*

85 Jason W. Yackee, *Pacta Sunt Servanda and State Promises to Foreign Investors Before Bilateral Investment Treaties: Myth and Reality*, 32 FORDHAM INT'L L.J. 1550, 1575 (2009).

86 20 I.L.M. 1-87, 81 (1981).

concessionaire.'[87] This includes lost future profits.[88] The arbitrator stated:

> In such confused state of international law, . . . it appears clearly that there is no conclusive evidence of the existence of community or uniformity in principles between the domestic law of Libya and international law concerning the determination of compensation for nationalization in lieu of specific performance, and in particular concerning the problem whether or not all or part of the loss of profits (*lucrum cessans*) should be included in that compensation in addition to the damage incurred (*damnum emergens*).[89]

The arbitral tribunal thus recognized that loss of future profits ought to be paid to LIAMCO. However, it deemed the naturalization legal. In determining the value of compensation due to it, LIAMCO hired an independent expert to make an evaluation. The expert estimated the amount of crude oil, liquids, and gas that would have been produced for the remainder of the contract. LIAMCO used the official market price of July 1976 to estimate the gross revenues that it would have made until the contract elapsed in 1988. It did not upwardly adjust this amount to take into account any future increases in market prices. LIAMCO then deducted operating costs and any taxes and royalties that it would have had to pay from this gross figure. The tax and royalty rates were based on those that existed prior to the nationalization measures taken in 1973. It applied a 12% discount factor to the net figure and the valuation came to $186,270,000.[90] The arbitral tribunal reduced this figure to $66,000,000, as 'equitable compensation,' reasoning that it did not take into account the currency inflation which was virtually certain to occur. [91]

The DCF method was also applied in the case of *Aminoil v. Kuwait.*[92] Although the arbitral tribunal deemed the nationalization to be legal, it did include lost future profits when it determined the compensation award. However, the arbitral tribunal examined all the circumstances of the case and opined that its award had to be consistent with the legitimate expectations of the parties concerned.[93] The tribunal further noted that "with reference to every long-term contract . . . there must necessarily be economic calculations, and the weighing-up of rights and obligations, of chances and risks, constituting the contractual equilibrium."[94]

In the tribunal's view, AMINOIL's expectations were reflected in the 1973 agreement between the parties. It had been subsequently modified by

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87 *Id.* at 60.
88 *Id.* at 81.
89 *Id.* at 76.
90 Gann, *supra* note 21, at 631.
91 *See* German Interests, *supra* note 9, at 160.
92 21 ILM 976 (1982).
93 *Id*. at ¶ 148.
94 *Id.*

the Abu Dhabi Formula, which led to the increase of tax and royalty rates payable to the government of Kuwait.[95] Given that AMINOIL had already agreed to this formula, any calculation of future lost profits would have to give due consideration to it. Therefore, the amount awarded to AMINOIL was based on a reasonable rate of return and not on the one presented, which was excessive given the lower taxes and royalty rates reflected in the earlier concession agreement.[96]

The International Centre of Investment Disputes (ICSID) tribunals have also included lost future profits in their awards. The first case that illustrates this is that of *AGIP v. Popular Republic of Congo.*[97] The claimant's interest in a Congolese company was nationalized by the government of Congo. The arbitral tribunal applied the law of Congo, which incorporated elements of the French Civil Code.[98] The aforementioned Code permitted recovery of lost future profits.[99] As such, the ICSID tribunal awarded lost future profits to AGIP.[100]

Thus, the ICSID Tribunal recognizes that lost future profits must be included in compensatory judgments. However, it is reluctant to award lost future profits in instances where they are indeterminable. Lost future profits are indeterminable in instances where the nationalized entity does not have a sufficient profit-making history. In these cases, any proposed figure would be purely speculative. For this reason, arbitral tribunals are reluctant to award lost future profits in these instances. This is illustrated in the case of *Benevuti et Bonfant v. People's Republic of Congo.*[101]

In this case, the government of Congo had nationalized a company in which Benevuti et Bonfant (B & B), an Italian corporation, had a 40% equity interest.[102] B & B had entered into an agreement with the Congolese government, under which they were to build a bottle manufacturing plant in the host State.[103] Plant production commenced in 1975. However, the owners of the corporation left Congo the following year, upon advice by the Italian Embassy, that their safety was in jeopardy.[104] Subsequently, the Congolese army occupied the plant. Although there was no formal act of expropriation, B & B contended that the actions of the Congolese government comprised a takeover of its interest in the operation.

The tribunal contended that it had the jurisdiction to decide the dispute *ex aequo et bono* (in justice and fairness), in accordance with Article 42(3)

95 *Id.* at ¶ 154.
96 *Id.* at ¶¶ 160-63.
97 21 ILM 726 (1982).
98 *Id.*
99 *Id.* 737 at ¶¶ 98-100.
100 *Id.* 739 ¶ 115(a)(ii)(D).
101 21 I.L.M. 740; (1982) (2014).
102 *Id.* at ¶ 2.6.
103 *Id.* at ¶ 2.9.
104 *Id.* at ¶ 2.23.

of the ICSID Convention.[105] B & B contended that the value of its 40% ownership interest was CFA 110,098,936. In calculating this figure, it accounted for projections of expected profits over the period of the agreement.[106]

The arbitral tribunal appointed an independent expert to make the valuation. The expert advised that future profits could not be included in the award because, during its one year of operation, the company had not realized any profits. Therefore, given that its profit-making history was non-existent, the expert treated the expropriated entity as a start-up, rather than a full-fledged business. The expert then made an evaluation based on the most objective criteria at this time. This involved examining the amount of the original investment and multiplying this by B & B's 40% interest. The expert's valuation totalled CFA 122,000,000,[107] a figure that exceeded the amount originally claimed by B & B.

Although the tribunal agreed with the expert opinion, it lowered B & B's award to CFA 110,098,936, the original figure it had claimed. The tribunal justified the reduction by reasoning that the claimant could not receive compensation greater than the damages claimed.[108] However, the tribunal did add interest to the award, which was applied from the date of the Congolese government's takeover of the B & B facility. B & B requested an interest rate of 15% but the arbitral tribunal awarded 10%, the rate the Congolese government used in their counterclaims. Invoking its authority to decide the matter *ex aequo et bono*, the tribunal opined that a rate of 10% was equitable under the circumstances.[109] This comports with the State Department's position on lost future profits. It acknowledges that under the general rule, lost future profits should be included in the compensation package, although this may not be practical if the amount of such profits is indeterminable.[110]

This position can be contrasted with the latter case of *SOABI v. Senegal*.[111] SOABI was a company controlled largely by Belgian interests. The project here involved the implementation of a project for the construction of low-income housing in Dakar, Senegal.[112] SOABI was also to construct a factory for the prefabrication of reinforced concrete.[113] The government of Senegal unilaterally terminated the underlying contract. As

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[105] *Id.* at ¶¶ 4.4, 4.65.
[106] *Id.* at ¶ 4.75.
[107] *Id.* at ¶ 4.78.
[108] *Id.* at ¶ 4.79.
[109] *Id.* at ¶ 4.98.
[110] Smith, *supra* note 17 at 519; Gann, *supra* note 21, at 625.
[111] Société Ouest Africaine des Bétons Industriels v. State of Senegal, ICSID Case No. ARB/82/1, 2 ICSID Rep. 164 (1988).
[112] Nassib G. Ziadé, *Some Recent Decisions in ICSID Cases*, 6 ICSID-REV. – FILJ, 515, 521 (1991).
[113] *Id.*

such, SOABI initiated arbitral proceedings against Senegal. The ICSID Tribunal held that Senegal was liable for the unilateral termination of the underlying contract and should therefore compensate SOABI. This included resulting damages (*damnum emergens*) and lost future profits (*lucrum cessans*), despite the fact that SOABI had not yet made any profits. This is consistent with earlier non-ICSID cases such as *Delagoa Bay and East African Railway*[114] and *Sapphire International.*[115]

In the *Delagao* case, the Portuguese government annulled a railroad concession before operations could commence.[116] Despite this, the tribunal opined that *lucrum cessans* were payable. Similarly, the tribunal in *Sapphire International* held that the claimant was entitled to lost future profits, despite the fact that the area in dispute had not even been prospected yet.[117] Since the *SOABI* decision, subsequent ICSID tribunals have been reluctant to award lost profits in instances where the claimant does not demonstrate a track record of profitability.[118] In this sense, the position in SOABI is more the exception than the norm.[119]

This section has shown that the State has a duty to pay compensation to the investor when it unilaterally terminates an agreement. Although there are currently two prevailing standards of compensation under international investment law, the case law shows that lost future profits are often included in the compensation package, even where the tribunal has elected appropriate compensation as the applicable standard. The only exception to this, is where such lost future profits are indeterminable. Moreover, international investment law makes no distinction between lawful and unlawful takings when awarding lost profits. Due regard must be given to future revenues the investor would have generated. Not doing so would be to "confiscate a portion of his or her property without compensation."[120]

3.0 THE EFFICIENT BREACH THEORY UNDER INTERNATIONAL INVESTMENT LAW

According to the efficient breach theory, "a party should be allowed to breach a contract and pay damages, if doing so would be more

[114] United States and Great Britain v. Portugal (1900) quoted in Majorie M. Whiteman, *Damages in International Law: Volume 3* 1694, 1697 (United States Government Printing Office, 1943).

[115] Sapphire Int'l Petroleum Ltd., *supra* note 75 at. 187-88.

[116] Whiteman, *supra* note 114, at 1697.

[117] Sapphire Int'l Petroleum Ltd., *supra note* 75, at 190.

[118] *See* Técnicas Medioambientales Tecmed SA v. United Mexican States, ICSID Case No, ARB (AF)/00/2 (2004); *see also* Wena Hotels Ltd v. Arab Republic of Egypt, ICSID Case No. ARB/98/4, 6 ICSID Rep. 67 (2000); Biloune and Marine Drive Complex Ltd v. Ghana Investments Centre and the Government of Ghana, 95 ILR 183 (1990).

[119] *See* MCLACHLAN, SHORE & WEINIGER, *supra* note 38, at 325.

[120] *See* Lieblich, *supra* note 74, at 47-48.

economically efficient than performing under the contract."[121] This theory espouses the view that contract law aims to promote efficient behavior. Parties entering into a mutually beneficial agreement are making each other better off.[122] Such mutually beneficial contracts promote 'welfare'[123] or 'wealth maximisation.'[124] The efficient breach theory operates under the auspices of 'utilitarianism.'[125] This ideology propounds the view that the law exists to promote the greatest good for the greatest number.[126] Although a plethora of utilitarian justifications exist within contract law, the efficient breach theory remains the most prominent of them.[127]

The term 'efficiency' is seen through the prism of two schools of thought: Pareto efficiency on the one hand, and Kaldor-Hicks efficiency on the other.[128] Pareto efficiency is divided into two categories: Pareto optimality and Pareto superiority. Pareto optimality considers behavior efficient if one party's welfare is enhanced at the expense of another.[129] Rules modelled after Pareto superiority, on the other hand, leave no person worse off and grant benefits to at least one person.[130]

Under Kaldor-Hicks efficiency, a rule is efficient if the benefits parties receive from the rule outweigh the losses incurred by those that might be harmed by it. As such, a transaction is efficient even if it produces winners and losers. Simply, the winners must gain more than the losers lose.[131] Under Kaldor-Hicks efficiency, compensation is not paid to the losers. The criterion is satisfied, "as long as the monetised value of the health gains for the winners is greater than the monetized loss of health for the losers."[132] If the transaction was without cost and full compensation is given to the losers, then the transaction is deemed to be Pareto superior, rather than

[121] *Black's Law Dictionary* 592 (9th ed. 2009).

[122] *See* Charles Fried, *Contract as Promise Thirty Years On,* 45 SUFFOLK U. L. REV. 961, 964 (2012).

[123] RICHARD A. POSNER, THE ECONOMICS OF JUSTICE 60-61 (1981).

[124] *See* Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 96 (2001); *see also* Gregory Klass, *The Rules of the Game and Morality of Efficient Breach*, 29 Y. J. L. & HUMAN. 71 (2017).

[125] PETER HALSTEAD, JURISPRUDENCE 72 (2005).

[126] *See* THE COLLECTED WORKS OF JEREMY BENTHAM: A COMMENT ON THE COMMENTARIES AND A FRAGMENT ON GOVERNMENT 393 (J.H. Burns & H.L.A. Hart eds., 1977).

[127] *See generally* STEPHEN A. SMITH, CONTRACT THEORY 136-40 (2004) [hereinafter SMITH, CONTRACT THEORY].

[128] Richard S. Markovits, *Constructive Critique of the Traditional Definition and Use of the Concept of the Effect of a Choice on Allocative (Economic) Efficiency,* 1993 U. ILL. L. REV. 485, 489 (1993).

[129] Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512-13 (1980).

[130] *Id.* at 513.

[131] *See* POSNER AND SYKES, *supra*, note 10 at 13.

[132] *Id.*

Kaldor-Hicks efficient. For this reason, it is advanced that Kaldor-Hicks efficiency is a 'potential Pareto-Superior' standard.[133] However, the difficulty with this proposition lies in the failure to compensate the loser in such a scenario. Consequently, individuals are left worse off, falling short of the conditions prescribed under Pareto superiority.[134]

The position espoused under Pareto superiority is more widely utilized as the standard in determining efficient behaviour under the efficient breach theory.[135] This is primarily because self-interested persons do not object to its use. Coleman advances that people would object to policies which would make at least one person better off, without anyone else suffering in the process.[136] Moreover, it has been observed that:

> Exchanges among knowledgeable, rational persons in a free market are generally Pareto superior; rational individuals do not strike bargains with one another unless each perceives it to be in his or her own interest to do so. A successful exchange between such parties is, therefore, one in which the value to each of what he or she relinquishes is perceived as less than the value of what each receives in return. Such exchanges make no individual worse off; often they improve the lot of all concerned. Pareto superiority is connected in this way to the ideal of a free-exchange market.[137]

On the other hand, Kaldor-Hicks efficiency requires a more complex evaluation of personal comparisons of welfare. Pareto efficiency simply asks whether everyone did or would agree to a decision.[138]

When it comes to remedies under contract law, the implications of the two theories of efficiency are very important. Contract law promotes efficiency through damages. This is underscored by the dominance of damages over specific performance in contract cases.[139] As such, if the promisor breaches an agreement, then he or she has an obligation to compensate the promisee for that breach. [140] Courts prefer damages over specific performance because in some instances, it might not be economically efficient to induce the promisor to complete specific

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[133] GUIDO CALABRESI AND PHILIP BOBBITT, TRAGIC CHOICES 85-86 (1978).

[134] *See* Coleman, *supra* note 129, at 513

[135] *Id.* at 520.

[136] *Id.* at 516.

[137] *Id.* at 516-17.

[138] SMITH, CONTRACT THEORY, *supra* note 127, at 110-11.

[139] *See* EDWIN PEEL, TREITEL: THE LAW OF CONTRACT 988, 1099 (13th ed. Sweet & Maxwell 2011).

[140] ROBERT UPEX AND GEOFFREY BENNETT, DAVIES ON CONTRACT 288-89 (10th ed. Sweet & Maxwell 2008); see also OLIVER W. HOLMES, THE COMMON LAW 300-01 (Macmillan 1882); *see also* Oliver W. Holmes, *The Path of the Law* 10 HARV. L. REV. 457 (1897).

performance of a contract.[141] This is illustrated in the following scenario:

> Suppose I sign a contract to deliver 100,000 custom-ground widgets at 10¢ apiece to A for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise he will be forced to close his pianola factory at great cost, and offers me 15¢ apiece for them. I sell him the widgets and as a result do not complete timely delivery to A, causing him to lose $1,000 in profits. Having obtained an additional profit of $1,250 on the sale to B, I am better off even after reimbursing A for his loss, and B is also better off. The breach is therefore Pareto superior. True had I refused to sell to B he could have gone to A and negotiated an assignment to him of part of A's contract to me. But this would have introduced an additional step, with additional transaction costs – and high ones, because it would be a bilateral monopoly negotiation. [142]

In such a scenario, efficiency would encourage the parties to repudiate their obligations "where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered."[143] Thus, the object of contract law aims to incentivize the promisor to fulfil his or her contractual obligations "unless the result would be an inefficient use of resources."[144]

In addition, the efficient breach theory does not constitute a 'prescriptive recommendation to act wrongfully' as claimed by some detractors.[145] Nor does it immorally enrich a party that breaches a contract as charged by others.[146] An act is only immoral if it is undertaken without consideration for the well-being and interests of other people.[147] The well-being of a disappointed promisee is sufficiently addressed under the efficient breach theory. The efficient breach theory ensures that disappointed promisees are paid damages. Damages are calculated so as to include future profits anticipated from a particular transaction.[148] The

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[141] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 150 (8th ed., Wolters Kluwer 2011).

[142] *Id.* at 151

[143] Robert Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970).

[144] POSNER, *supra* note 141, at 150.

[145] Seana V. Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 733 (2007).

[146] *See* Daniel Friedman, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1 (1989); Shiffrin, *supra* note 145, at 708; *see also* Avery Katz, *Virtue Ethics and Efficient Breach*, 45 SUFFOLK U. L. REV., 777 (2012); *but cf.* Daniel Markovits and Alan Schwartz, *The Myth of Efficient Breach: New Defenses of the Expectation Interest*, VA. L. REV. 1939, 1948 (2011).

[147] Charles Fried, *The Convergence of Contract and Promise*, 120 HARV. L. REV. F. 1, 3 (2007).

[148] POSNER, *supra* note 141, at 150-51.

inclusion of lost future profits in a compensation package of this sort effectively places the disappointed promisee in the position that he or she would have occupied had the breach not taken place. Once the promisee is restored to this position, whether or not the contract is completed ceases to be of consequence. In other words, the promisee is rendered indifferent as to whether the promisor completes the contract or not. The fact that lost future profits are included in the compensation package, means that the promisor is deterred from breaching the contract unless they can both: (1) compensate the investor; and (2) still make a profit over and above the amount they have compensated.[149]

Compensation is also the dominant remedy under international investment law, just as it is under domestic contract law of most common law countries. Although there are a number of advantages to specific performance,[150] compensation is a more practical option under international investment law. Specific performance is difficult to enforce. This was certainly illustrated in the case of *LIAMCO v. Libya*. There, the tribunal rejected LIAMCO's claims for specific performance, because such a remedy would be impossible to implement.[151] This is owing to "prevalent international practice" and the fact that it was "practically incapable of compulsory execution[.]"[152] Furthermore, ordering specific performance militates against the State's right to nationalize a private entity. The tribunal decided that the nationalization was lawful, provided it was non-discriminatory and not accompanied by a wrongful act. Therefore, the arbitral tribunal in *LIAMCO v. Libya*, refused to reverse the nationalization and accordingly rejected specific performance as a remedy.[153]

On a broader level, international investment law promotes efficiency by addressing the risks proceeding from long-term investment projects.[154] The rules and devices that exist effectively prevent the host State from taking advantage of the investor once the latter has sunk his or her investment.[155] Without these mechanisms, any undertakings made by the

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[149] *Id.*

[150] Friedman, *supra* note 146, at 7; *see also* Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 94 CAL. L. REV. 975 (2005); Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 YALE L. J. 571 (2006); *but cf.* Jody S. Kraus, *A Critique of the Efficient Performance Hypothesis*, 116 YALE L. J. POCKET PART 423 (2007).

[151] LIAMCO v. Libya, *supra* note 86, at 85-86; *See also* Haliburton Fales, *A Comparison of Compensation for Nationalization of Alien Property with Standards of Compensation under United States Domestic Law,* 5 NW. J. INT'L L. & BUS. 871, 888 (1983); *but cf.* Texaco v. Libya 17 I.L.M. 1 (1978).

[152] LIAMCO v. Libya, *supra* note 86.

[153] LIAMCO v. Libya, *supra* note 86, at 85-86; *see also* Fales, *supra* note 151; *but cf.* Texaco v. Libya, *supra* note 151.

[154] RUDOLPH DOLZER AND CHRISTOPH SCHREUER, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW 22 (2d ed. 2012).

[155] POSNER & SYKES, *supra* note 10, at 288-97.

host State are subject to reversal once the investment has sunk and operations have commenced. For example, the host State could tax the investor heavily, or nationalize their business outright.[156] Contractual mechanisms protect against this, and are contained within agreements between the host State and the investor. There are also protections found in national law, international law and Bilateral Investment Treaties (BITs).[157] Furthermore, international arbitration provides a forum under which aggrieved investors can bring action against a host State that has violated an agreement. This allows the investor to bring an action in a private and neutral forum rather than the national courts, which have the potential for bias against the investor. Arbitration proceedings also benefit from international conventions prescribing the mechanisms under which arbitral awards are enforced.[158]

It is advanced that international investment law encourages parties to comply with their obligations under a concession agreement, unless so doing would be inefficient.[159] This is evinced by the compensation regime under international investment law. As shown in the preceding section, if a State breaches a concession agreement then it has an obligation to compensate the investor.

As is the case found under law found in the domestic, rather than international forum, compensation under international investment law requires restoring the investor to the position they would have been in had the breach not taken place. This includes not only compensating them for sunk costs, but also for lost future profits. If the State makes a profit, even after compensating the investor, inclusive of lost future profits, then the State has theoretically acted efficiently. This proceeds from the State making a gain while the investor loses nothing, thus falling within the parameters of Pareto efficiency. If the State cannot achieve that end, then the compensation regime acts as a deterrent towards terminating the concession agreement.

Marsh argues that, "an expropriation or nationalization spurned by an obsolescing bargain will realize a net loss."[160] Such an action would result in economic harm to the investor. Foreign investors may be reluctant to invest in a State that does not meet its contractual obligations.

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156 *Id.* at 288. *See also* Edith Penrose, George Joffé, & Paul Stevens, *Nationalization of Foreign-Owned Property for a Public Purpose: An Economic Perspective on Appropriate Compensation*, 55 MOD. L. REV. 351, 354-55 (1992).

157 *See generally* SALACUSE, *supra* note 1.

158 POSNER & SYKES, *supra* note 10, at 295.

159 Louis T. Wells, *Double Dipping in the Arbitration Awards? An Economist Questions Damages Awarded to Karaha Boadas Company in Indonesia*, 19 ARB. INT'L 471, 478 (2003).

160 Brandon Marsh, *Preventing the Inevitable: The Benefits of Contractual Risk Engineering in the Light of Venezuela's Recent Oil Field Nationalization*, 13 STAN. J. L. BUS. & FIN. 453, 457-58 (2008).

Consequently, the host State loses in the long-term, even if they realize a short-term benefit. This is further compounded by the fact that nationalized entities tend not to be as profitable as privatized ones.[161] This is because of reduced levels of present and future investment.[162] This, coupled with outright mismanagement, means that nationalized entities produce less, which in turn has an adverse effect on the economy.[163]

The first part of this argument, that state expropriation or forced nationalization harms investors, fails. The host State will have to pay the investor lost future profits. The investor thus loses nothing because they are restored to the position they would have been in had the contractual breach not taken place. Even if the compensation regime was non-existent, the investor still has access to insurance facilities such as the Multilateral Investment Guarantee Agency (MIGA), which cover various political risks.[164] Moreover, investors still go on to invest their capital in countries with a history of unilaterally terminating concession agreements.[165]

The latter half of the argument above, that the State loses in the long term when breaching foreign investment contracts, touches upon a very pertinent point: that economic efficiency is not as central to the objectives of the State as it is to foreign investors. Foreign investors are private entities and typically seek profit above other priorities. However, States do not seek to maximize wealth because their priorities are socio-economic.[166] The assumption of the efficient breach theory, is that all parties to the contract are seeking to maximize wealth. Wealth maximization is defined strictly in monetary terms.[167] Wealth maximization is seen as a factor determining whether a certain state of affairs is efficient or not.[168]

A State will certainly weigh its options before it violates an agreement.[169] However, wealth maximization is typically a peripheral

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[161] SANGWANI PATRICK NG'AMBI, RESOURCE NATIONALISM IN INTERNATIONAL INVESTMENT LAW 95 (2016).

[162] *Id.*

[163] Marsh, *supra note* 160.

[164] *See* S. Linn Williams, *Political and Other Risk Insurance: OPIC, MIGA, EXIMBANK and Other Providers*, 5 PACE INT'L L. REV. 59 (1993).

[165] *See generally* Paul Stevens, *National Oil Companies and International Oil Companies in the Middle East: Under the Shadow of Government and the Resource Nationalism Cycle*, 1 J. WORLD ENERGY L. & BUS. 5. (2008).

[166] NG'AMBI, *supra* note 161, at 96.

[167] See Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 119 (1979) (stating that "wealth is the value in dollars or dollar equivalents (an important qualification, as we are about to see) of everything in society. It is measured by what people are willing to pay for something or, if they already own it, what they demand in money to give it up. The only kind of preference that counts in a system of wealth maximization is thus one that is backed up by money—in other words, that is registered in a market.").

[168] Coleman, *supra* note 129, at 23, 526.

[169] Richard Morrison, *Efficient Breach of International Agreements*, 23 DENVER J. OF

consideration because nationalizations, or termination of a concession, invariably take place when resource-rich nations wish to make changes to their socioeconomic systems.[170] The duty to pay full market value, including lost future profits, instead of book value, effectively dissuades host States from pursuing this legitimate purpose.[171]

When the Zambian government nationalized the country's copper mines in the 1970s, for example, it cited socio-economic reasons.[172] The government of Zambia cited the need to raise the standards of living of the poor.[173] In addition, the government was concerned that the mining industry, which made up a sizeable portion of the Zambian economy, was dominated by two foreign entities: Anglo-American Corporation and the Roan Selection Trust.[174] As such, the government's main concern was that Zambia's socio-economic interests were subservient to the commercial interests of the two aforementioned companies. In 2008, the government of Zambia once again cited socio-economic reasons when they introduced a windfall tax on mining companies.[175] The government of Zambia proceeded to amend the favourable tax regime that mining companies had previously enjoyed, when copper prices rose from $1,779 per ton in 2003 to $6,438 per ton in 2008.[176]

Similarly, when Venezuela nationalized its oil companies in the 1970s, it also expressed concerns about the backbone of its economy being dominated by foreign-owned interests.[177] Governments may also nationalize because they are seeking to correct what they perceive as a colonial wrong.[178] This was certainly the case when the Zimbabwean government nationalized white-owned farms.[179] Although Zimbabwean farm nationalization does not deal with a concession per se, it underscores

INT'L L. & POLICY 183, 188 (1994).

[170] Maarten H. Muller, *Compensation for Nationalization: A North-South Dialogue*, 19 COLUM. J. TRANSNAT'L L. 35, 45 (1981). *See also* Margot E. Salomon, *From NIEO to Now and the Unfinishable Story of Economic Justice*, 62 INT'L & COMP. L. Q. 31, 36-46 (2013); Nordine Ait-Laoussine & John Gault, *Nationalization, Privatization and Diversification*, 10 J. WORLD ENERGY L. & BUS. 43 (2017).

[171] Muller, *supra* note 170.

[172] Daniel Limpitlaw, *Nationalization and Mining: Lessons from Zambia*, 111 J. S. AFR. INST. MINING & METALLURGY 737, 737 (2011).

[173] *Id.*

[174] Sangwani Patrick Ng'ambi, *Mineral Taxation and Resource Nationalism in Zambia*, S. AFR. J. POL'Y & DEV. 6, 10 (2015).

[175] *See generally* NG'AMBI, *supra* note 161.

[176] Sangwani Ng'ambi, *Stabilization Clauses and the Zambian Windfall Tax*, 1 ZAM. SOC. SCI. J. 107, 113 (2011).

[177] Felix P. Rossi-Guerrero, *The Transition from Private to Public Control in the Venezuelan Petroleum Industry*, 9 VAND. J. TRANSNAT'L L. 475, 482 (1976).

[178] *See* Dunia Zongwe, *The Contribution of* Campbell v. Zimbabwe *to the Foreign Investment Law on Expropriations*, 2 NAMIB. L. J. 31 (2010).

[179] *Id.*

the contention that when a government expropriates property or breaches a concession, it does not necessarily do so for the purposes of wealth maximization. That the State must pay future profits may make it more onerous to pursue those goals. Given this, States need some form of flexibility when dealing with "legitimate changes and circumstances."[180] The rules, as they stand, do not permit the State that flexibility.

In sum, the efficient breach theory posits that parties can breach a contract and pay damages in lieu of performance if doing so would be economically efficient. At the international level, compensation rather than specific performance is the dominant remedy. Once the State unilaterally terminates a concession agreement, it must compensate any related investor. The compensation package invariably includes lost future profits. If the State breaches an agreement, compensates the investor and still makes a profit after doing so, it may have acted efficiently.

In this respect, the international investment law rules promote efficiency, as prescribed under the efficient breach theory. However, the efficient breach theory ignores that not all parties to a contract are necessarily concerned with wealth maximization. Thus, while the rules on compensation under international investment law promote efficiency, they do not give the host State the sufficient flexibility needed in order to pursue legitimate public functions.

4.0 CONCLUSION

When a State unilaterally abrogates its contractual obligations, it is under a duty to compensate the investor. Damages aim to restore the investor to the position they would have been in had the breach not taken place. This not only includes *damnum emergens*, it also includes *lucrum cessans*. Such damages are awarded regardless of whether the taking is deemed legal or illegal by arbitral tribunals.

The rules relating to compensation under international investment law promote efficiency because they prevent governments from unilaterally abrogating contracts unless they can compensate the investor. This includes lost future profits while retaining a net profit. The difficulty with payment of future profits in the States' case, however, is that it makes it more onerous for the host State to pursue its legitimate public functions. States usually cite socio-economic reasons for their termination, rather than simply maximizing profits as espoused under the efficient breach theory. This can be contrasted with commercial actors whose only concern is making money.

Therefore, there is a limitation to the efficient breach theory, in that it focuses more on wealth maximization. This presupposes that contract law only governs activities of profit-maximizing market participants. This is not

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[180] POSNER & SYKES, *supra* note 10, at 289.

quite the case in international investment law. On the one hand, there is a private entity looking to make profit. On the other, we have the State, whose objectives are wider than just commercial. In this sense, one would argue that whilst international investment law promotes efficiency, it does not provide the States with sufficient flexibility to pursue its legitimate public objectives, when it breaches agreements.