NEWS

Kahale on the “new age of the megacase”

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George Kahale in Prague

In a speech in Prague, Curtis Mallet Prevost Colt & Mosle chairman **George Kahale III** argued that investor-state dispute settlement is a deeply flawed system that should be dismantled completely or rebuilt from scratch – with a focus on deficiencies in how tribunals deal with quantum in the “new age of the megacase”. **Jaroslav Kudrna** and **Anna Bilanová** of the Czech Ministry of Finance report.

Kahale acknowledged in his speech that he has long been a “beneficiary” of the current ISDS system through his work defending many states but that this did not deter him from calling ISDS “the Wild Wild West of international practice”.

He argued that in far too many cases “what formerly would be considered legitimate government regulation is characterised as breaches of treaty obligations that the treaty

negotiators never thought existed". This overly broad interpretation of basic concepts such as fair and equitable treatment amounted to a gross misapplication of international law. In addition, entrusting decision making under investment treaties to the ISDS has transformed those treaties into "weapons of legal destruction".

Kahale observed that basically any government regulation might be a basis for an investment claim, especially where an investor is supported by an army of competent counsel, experts and third-party funders. Further, due to "the lack of the normal safeguards of a serious legal system", an investor has always a chance that some tribunal will find even a far-stretched claim well founded. We have already seen "many strange and frankly indefensible decisions" rendered, he suggested.

To make things even worse, the system allows these decisions to be used as precedent to support positions the contracting states have not signed up for. Unfortunately, departures from the original state intent "generally only go in one direction" – that is, towards the expansion of investor protection. He said increasing numbers of states were frustrated by this "one-way street". Kahale said his own experience of ISDS confirmed his view that the system was biased against states, notwithstanding statistical studies that suggest states win more cases than they lose.

Even if some could argue that the number of shocking decisions is not significant, one shocking decision per year is enough considering the issues and money at stake, Kahale said. Quantum is often not given enough attention by counsel and arbitrators who are more comfortable with the legal issues surrounding jurisdiction and merits. Kahale therefore focused his attention on damages.

First, Kahale pointed out that counsel and arbitrators should be careful of ceding quantum issues to experts. Counsel should master the quantum issues because without "that basic knowledge and comfort level, the lawyer is at a distinct disadvantage, which can prove very costly."

Second, he observed the size of today's ISDS claims reach astronomic proportions amounting to tens of billions of US dollars in some cases. According to him, we have entered a "new age of the megacase." In this new age, even one mistake a year is too much and "mistakes are not rare in this business."

Kahale next turned to the discounted cash-flow (DCF) valuation method used by experts. The object of DCF is to determine the fair market value of an interest by estimating future cash flows and applying a discount rate to them. This exercise, however, requires making projections or assumptions encompassing potential costs and revenues over the estimated lifetime of the investment. According to Kahale, such assumptions require a "crystal ball" and it is virtually certain that they will "turn out wrong". Imaginative claimants aided by their experts can also misapply DCF to justify valuations reaching "wonderland proportions", he suggested.

He noted that the DCF method should be used with caution and only for a business that is a "going concern" with some history of profitability. This has been already articulated by the World Bank Guidelines on the Treatment of Foreign Direct Investment in 1992.

Kahale said that projecting and making assumptions without any track record of profitability crosses to the realm of fantasy. He commended the approach of tribunals in cases such as *SPP, Wena Hotels, Caratube* or *Bear Creek* that have rejected the use of DCF either because the business being valued had no track record at all or was operating for too short a period to provide reliable data.

However, he said there were many examples of claimants making billion-dollar claims based on "relatively insignificant investments" in businesses that never commenced operations. He mentioned a recent contract-based case against Nigeria where the claimant won US$6.6 billion for a gas refining business for which no plant had ever been constructed. Similarly, in a case against Libya, an investor won almost a billion dollars for a tourist project that had never commenced, in which it had invested only US$5 million.

"One has to ask: at what point will these awards become so shocking that the international arbitration community, and indeed the international community at large, will say 'enough is enough'?" Kahale asked.

Finally, Kahale turned to the determination of the appropriate discount rate where the DCF method is used. He addressed two ICSID cases against Venezuela: *Gold Reserve* and *Tidewater*, in which the same quantum expert appeared for the claimants in both cases but the two tribunals came to different determinations in regard to country risk, which influenced the determination of the discount rate. The difference in the applied discount rate in the two cases amounted to more than 15%. If the tribunal in *Gold Reserve* had taken the approach of the tribunal in *Tidewater*, the amount of damages awarded would have been completely different. The difference in applicable discount rate can thus amount to billions, he observed. What can be done to remedy the issues identified above? Kahale said he was sceptical that any change will come soon and worried that the cure could be worse than the disease. Current discussions in the UNCITRAL Working Group III about reforms of ISDS might not lead to desired solutions because they only concern procedural issues, he suggested. Kahale also said the tendency to accommodate the interests of all supposed stakeholders would in this case be a "recipe for disaster".

Therefore, Kahale referred to his long-held view that the ISDS system "should be dismantled and either discarded or rebuilt from scratch". A remade ISDS should incorporate new substantive rules that have "a solid foundation in international law" and extend to recurring quantum issues.

Kahale proposed a three-pronged approach. First, states should continue focusing on the deficiencies of the current system but no magical solution should be expected from the deliberations at the UNCITRAL Working Group III.

Second, he encouraged states to actively explore the termination of ISDS provisions in international treaties. He noted that the United States had recently done just that in its renegotiation of NAFTA, ending ISDS with respect to Canada and limiting it with respect to Mexico. While Kahale said he did not agree with the "motivations behind that action", which appeared to stem from a desire to discourage investment abroad and a scepticism about international law in general, he said that "ending or limiting a system as defective and dangerous as ISDS is a good thing, even if it is done for the wrong reasons".

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Finally, Kahale recognised that it might not be possible to end all ISDS provisions and that states should focus on "putting the brakes on this out-of-control development" of investment law. He encouraged states to seek agreement on the interpretation of the substantive concepts in their treaties. States routinely take certain positions when claims are made, he noted. "I say why wait for the claims to come."

Kahale was delivering the keynote address at the 8th Investment Treaty Arbitration Conference in Prague on 25 October. The conference, organised by the Czech Ministry of Finance and hosted by KPMG, fosters an exchange of experiences in treaty arbitration between senior government officials and top legal practitioners in the field.

The three-day event included workshops for government officials focused on current institutional developments and issues relevant to the defence of states in investment arbitrations, a quantum seminar presented by KPMG and ICC YAF event on security for costs and conflicts of interest.

Speakers at the main conference included **Eduardo Silva Romero** of Dechert, **Paolo Di Rosa** of Arnold & Porter, **George von Mehren** of Squire Patton Boggs, **Dietmar Prager**of Debevoise & Plimpton, **Aníbal Saber** of Chaffetz Lindsey, **Michael Ostrove** of DLA Piper, **David Pinsky** of Covington & Burling, **Andrea Menaker** of White & Case, **Michael Sullivan QC** of One Essex Court and **Miriam Harwood**, also of Curtis Mallet.

The next conference will take place in Prague in October next year.

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