

# Pricing Compliance: When Formal Remedies Displace Reputational Sanctions

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## INTRODUCTION

When can dispute resolution decrease the level of obligation in an international agreement? The general assumption in international relations and international law is that dispute resolution is a commitment mechanism. Theoretical accounts maintain that dispute resolution provisions raise the reputational costs of breaching treaty rules. In empirical studies, dispute resolution provisions are treated as an indicator of greater obligation. This Article argues that dispute resolution provisions can sometimes make international legal obligation easier to breach, and that governments may design dispute resolution systems to facilitate breach, rather than deter it. Where dispute resolution systems include specific remedy provisions, the system may price breach, permitting states to deviate from the agreement so long as the remedy is paid. By selling an alternative to compliance, dispute resolution systems can decrease the reputational costs of breach and provide governments with great flexibility in meeting their international obligations.

Within the international law and international relations fields, reputation is considered one of the primary means to promote state compliance with international rules and dispute resolution decisions.<sup>1</sup> Despite disciplinary

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1. See generally ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984); JACK GOLDSMITH & ERIC POSNER, *THE LIMITS OF INTERNATIONAL LAW* (2005); ANDREW GUZMAN, *HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY* (2008) [hereinafter *HOW INTERNATIONAL LAW WORKS*]; ROBERT O. KEOHANE, *AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY* 105–08 (1984); ROBERT SCOTT & PAUL STEPHAN, *THE LIMITS OF THE LEVIATHAN: CONTRACT THEORY AND THE ENFORCEMENT OF INTERNATIONAL LAW* (2006) [hereinafter *SCOTT & STEPHAN, THE LIMITS OF THE LEVIATHAN*]; MICHAEL TOMZ, *REPUTATION AND INTERNATIONAL COOPERATION: SOVEREIGN DEBT ACROSS THREE CENTURIES* (2007). See generally Oona Hathaway, *Between Power and Principle: An Integrated Theory of International Law*, 72 U. CHI. L. REV. 469 (2005);

differences, both fields have independently emphasized the positive role of reputation in sustaining international cooperation without a centralized enforcement system. In addition, the conventional wisdom holds that formal dispute resolution heightens the reputational costs of noncompliance to governments. The logic is that states face greater reputational losses from noncompliance because a dispute resolution body authoritatively adjudicates whether a government has breached an agreement and then widely broadcasts the state's breach to the international audience.<sup>2</sup> This is damaging to the state because it publicizes the state's noncompliance and thus reduces its future opportunities to form treaties.<sup>3</sup> Drawing on this logic, some international law scholars argue that the potential reputational costs of having a dispute resolution institution are so significant that states are reluctant to establish international courts even if there would be some functional gains from having such a system.<sup>4</sup>

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Laurence R. Helfer, *Response, Not Fully Committed? Reservations, Risk, and Treaty Design*, 31 YALE J. INT'L L. 367, 369 (2006) [hereinafter Helfer, *Reservations*]; Paul R. Milgrom, Douglass C. North & Barry R. Weingast, *The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges, and Champagne Fairs*, 2 ECON. & POL. 1 (1990); George Norman & Joel Trachtman, *The Customary International Law Game*, 99 AM. J. INT'L L. 541, 567 (2005); Joost Pauwelyn, *The Calculation and Design of Trade Retaliation in Context: What is the Goal of Suspending WTO Obligations?*, in THE LAW, ECONOMICS, AND POLITICS OF RETALIATION IN WTO DISPUTE RESOLUTION 34 (Chad P. Bown & Joost Pauwelyn eds., 2010); Eric A. Posner & John C. Yoo, *Judicial Independence in International Tribunals*, 93 CAL. L. REV. 1, 17–18 (2005); Eric A. Posner & John C. Yoo, *Reply to Helfer and Slaughter*, 93 CAL. L. REV. 957, 959–60 (2005) [hereinafter *Judicial Independence*]; Kal Raustiala, *Form and Substance in International Agreements*, 99 AM. J. INT'L L. 581 (2005); Warren F. Schwartz & Alan O. Sykes, *The Economic Structure of Renegotiation and Dispute Resolution in the World Trade Organization*, 31 J. LEGAL STUD. S179 (2002); Robert E. Scott & Paul B. Stephan, *Self-Enforcing International Agreements and the Limits of Coercion*, 2004 WIS. L. REV. 551 (2004) [hereinafter Scott & Stephan, *Self-Enforcing Agreements*]; Beth A. Simmons, *International Law and State Behavior: Commitment and Compliance in International Monetary Affairs*, 94 AM. POL. SCI. REV. 819 (2000).

2. Kenneth Abbott & Duncal Snidal, *Hard and Soft Law in International Governance*, 54 INT'L ORG. 421, 427–30 (2000) ("Because legal review allows allegations and defenses to be tested under accepted standards and procedures, it increases reputational costs if a violation is found."); Laurence Helfer & Ann-Marie Slaughter, *Why States Create International Tribunals: A Response to Posner & Yoo*, 93 CAL. L. REV. 899, 934–35 (2005) [hereinafter Helfer & Slaughter, *International Tribunals*] (noting that dispute resolution institutions brand violators and lead to reputational losses for the state that will, in turn, make it more difficult for the state to join future agreements); Raustiala, *supra* note 1, at 606–13 (2005) (noting that international courts improve compliance with international law by raising the reputational costs to states of breach); Schwartz & Sykes, *supra* note 1, at S197 (2002) (noting that "the value of a central dispute resolution authority [is] to hear the merits of complaints, even if that authority has no power to authorize sanctions. By serving as a vehicle for transmitting information about violations throughout the trading system, central dispute resolution enhances the reputational costs of cheating").

3. Abbott & Snidal, *supra* note 2, at 427; Posner & Yoo, *Judicial Independence*, *supra* note 1, at 17–18; Raustiala, *supra* note 1, at 606; Schwartz & Sykes, *supra* note 1, at S196–97 (noting that nations that renege on promises will have less favorable future dealings not only with the injured nation but with all nations that observe the breach).

4. See generally Andrew Guzman, *The Cost of Credibility: Explaining Resistance to International Dispute Resolution*, 31 J. LEGAL STUD. 303 (2002) [hereinafter Guzman, *The Cost of Credibility*] (arguing that states will often refuse to create third-party dispute settlement mechanisms because these mechanisms impose reputational costs on the losing state without creating significant benefits for the successful state).

The conventional wisdom further maintains that the dispute resolution system that includes formal remedies and reputational costs are additive. Formal remedies, such as restrictive access to foreign markets or monetary losses, build onto the pre-existing reputational costs that a state suffers. Formal remedies thus uniformly raise the costs of deviating from international law. As such, international law scholars argue, reputational concerns and formal remedies will act in combination as a stronger deterrent to states, leading to greater compliance with international law. If states deviate from international law when the benefits of doing so outweigh the costs,<sup>5</sup> and if dispute resolution institutions raise the costs of noncompliance, then the hardening of international law, by establishing formal adjudication or explicit remedies, will lead to better enforcement of international rules, as compared to a system without dispute resolution.

This widely-accepted view that dispute resolution consistently raises the reputational costs of noncompliance to states is exaggerated and (in some instances) mistaken. This Article argues that dispute resolution institutions can (but will not always) *lower* the reputational losses associated with breach. The essential contention of this Article is that international dispute resolution institutions can lead the audience to lower its perception of the importance of compliance and view the breaching state as cooperative if it abides by the remedy regime. Formal remedies can serve as a fine rather than a sanction. As framed by Robert Cooter, fines “price” breach. If paid, the fine eliminates, or at least decreases, the reputational costs of the deviation, because the appropriate remedy has been offered. In contrast, sanctions punish breach but do not excuse it. This Article articulates how the process of incorporating a dispute resolution system with formal remedies into a treaty regime can price breach by changing the audience’s perception of the mandatory nature of a treaty’s substantive provisions.

This insight highlights an important institutional design element that has been overlooked by international relations scholars: states may create dispute resolution systems to facilitate breach, rather than to deter it. Dispute resolution systems can serve as a pricing mechanism, designed by negotiators to allow states to make use of the remedy regime as an alternative to performance. The addition of a remedy regime may lead the audience to view the “cooperative equilibrium” that the treaty represents as not demanding compliance, but selling an option to breach at a price. Accordingly, the audience may view the treaty as accepting breach if the remedies are met, particularly when the treaty regime provides for remedies that are less than what is necessary to deter breach. As such, a state that deviates from the treaty’s substantive provisions, but continues to abide by the treaty’s second-order rules (that is, the dispute resolution procedures and the remedy regime) can be viewed as cooperative. While the breaching state

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5. See generally GOLDSMITH & POSNER, *supra* note 1; GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1; SIMMONS, *supra* note 1.

may suffer *some* reputational loss—as compliance with the treaty’s substantive rules may be preferred to compliance with the treaty’s dispute resolution rules—this reputational loss will be less than the loss that the state would have suffered if the treaty did not have a dispute resolution system.<sup>6</sup>

Dispute resolution systems can decrease the reputational costs of deviations from a treaty regime in two ways: (1) by establishing beliefs in the relevant audience that breach of a treaty’s substantive terms is acceptable if the remedies are met; and (2) by permitting states to demonstrate their cooperativeness by abiding by the treaty’s remedy regime.

First, the dispute resolution system can shape the audience’s beliefs regarding the nature of treaty obligations, especially with regard to whether and under which circumstances breach is acceptable. This Article argues that a treaty’s substantive obligations and its dispute resolution system are not analytically independent. Treaty obligations have a clear and uncontroversial relationship to the dispute resolution system; substantive treaty provisions supply the inputs for dispute resolution. Without treaty obligations, there can be no substantive law for a third party to adjudicate. Without breach, there is no need to discuss remedies. Less obvious is the other part of this relationship: the feedback effect between the dispute resolution system and treaty obligations. The treaty’s remedies have an influence on the audience’s perception of the nature of the treaty’s obligations and thereby influence the reputational effects of breaching the treaty’s substantive provisions.

This influence can work in either a positive or a negative direction. If the treaty imposes remedies that eliminate the gains from breach or require additional punitive damages, this remedy can act as a sanction and revise upward the audience’s beliefs about the mandatory nature of the treaty obligation. In such a situation, dispute resolution would work much as the conventional wisdom predicts. The breaching party may suffer a reputational loss as a result of breach in addition to the treaty’s formal sanctions.<sup>7</sup> In contrast, if the treaty imposes less than deterrence-level damages, such as compensatory damages or exclusively prospective damages, this remedy can act as a price for the breach and revise downward the audience’s beliefs about the importance of compliance. In such a situation, the remedy regime may serve to price breach rather than eliminate it or even stigmatize it. Remedies thus have the potential to redefine noncompliance as a violation of the

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6. My claim is a relative one: dispute resolution institutions can reduce a government’s reputational sanctions from breach *relative to* a state of the world without such institutions. The argument is not that dispute resolution systems will eliminate or substantially lower reputational sanctions in all circumstances. Instead, I examine whether dispute resolution systems can decrease such sanctions as compared to a world without dispute resolution regimes.

7. The relationship may not work in this direction if formal sanctions “crowd out” informal sanctions. See SCOTT & STEPHAN, LIMITS OF THE LEVIATHAN, *supra* note 1, at 23 (arguing that formal institutions can crowd out reciprocity and reputational effects). I discuss the possibility of both upward revision and crowding out *infra*.

treaty's remedy rules or as the failure to pay remedies when ordered, rather than as a breach of the substantive rules of the regime. In short, an alternative to compliance can be sold.

Second, dispute resolution institutions permit the breaching state to demonstrate its cooperativeness by accepting the authority of the dispute settlement institution. In this sense, much of the reputational effect of dispute resolution may come not from the finding or publicity of breach, but instead from the state's response to that finding. In the international system, compliance with remedy regimes, like compliance with substantive rules, is essentially voluntary. Thus, a government's compliance with the treaty's dispute resolution system, including the alteration of its policy after a case is adjudicated or its acceptance of the regime's remedies for breach, can signal to the audience the government's commitment to the treaty's goals and willingness to comply with the broader treaty regime (the treaty's second-order rules). This is different from the domestic law realm, in which complaining parties use the coercive power of the state to enforce the remedy orders of judges or arbitrators. In the domestic context, the payment of a remedy award says little about the cooperativeness of a contract partner. In contrast, a state's voluntary assent to a tribunal-ordered remedy demonstrates cooperation. Compliance with second-order rules can even become the operative metric for the audience's reputational analysis.

Understanding the relationship between dispute resolution institutions and reputational costs is essential to an evaluation of several key institutional design issues. The design of optimal remedy regimes requires a theory of how reputational concerns will interact with formal remedies, including monetary damages, other forms of compensation, and authorizations to resort to self-help. This includes an awareness of how the remedies will shape the audience's perception of the treaty obligations, as well as the possibility that formal sanctions may not be additive to informal sanctions. Otherwise, dispute resolution systems may result in higher or lower sanctions than the treaty designers intended.

An important implication of the optimal remedy approach, which this Article explores, is the idea that governments may create formal dispute resolution systems to lower the costs of deviation rather than to raise them. Remedy regimes can lower the reputational costs of breach and permit governments to treat remedies as an alternative to compliance at a set price. This is contrary to the prevailing view among international law scholars that formal dispute resolution systems will always increase the level of compliance with international rules. These scholars argue that a system of independent international tribunals can increase states' compliance with international law, relying in part on governments' concerns about their rep-

utations to support their argument.<sup>8</sup> This claim is not necessarily mistaken, but, in some cases, a different causal relationship may exist. I demonstrate that, by embedding dispute resolution within a broader cooperative arrangement, formal dispute resolution institutions may alter the audience's understanding of what the treaty's cooperative equilibrium entails and, for some treaties, lower the reputational costs of deviations from substantive rules. Therefore, negotiators may create a system of third-party adjudication and remedies specifically as a means of facilitating breach.

As used in this Article, the terms breach and violation have different and specific meanings. Breach refers to a deviation from the substantive terms of a treaty; any state action that is contrary to the first-order rules of an agreement is a breach. Breaches can be resolved within the treaty's framework through dispute resolution and remedies. In contrast, a violation of a treaty signifies a deviation from the dispute resolution rules; any state action that is contrary to the second-order rules of the agreement, such as refusing to pay any remedial damages, is a violation. Using these definitions, a state can breach a treaty (deviating from its substantive rules) without violating the treaty (deviating from its second-order rules). Any time a state breaches a treaty's substantive terms, it can stay within the treaty's framework (not violating the treaty) by accepting the jurisdiction of the dispute resolution system and complying with the remedy. In my analysis, a state both breaches and violates the treaty when it deviates from the substantive rules of the regime and refuses to comply with the dispute settlement system.<sup>9</sup>

Part I begins by establishing the prevailing view of the state's "reputation for cooperativeness" in the international law and international relations literature. This section demonstrates that the prevailing view generally holds that states develop good reputations in order to have future opportunities to join treaty regimes, and that dispute resolution institutions consistently raise the reputational costs of deviating from treaty obligations. Part II challenges this prevailing view by articulating how dispute resolution institutions can influence the audience's understanding of a deviation from a treaty regime, thereby altering the reputational importance of a state's breach. This section builds on Robert Scott and Paul Stephan's important discussion of how formal courts can crowd out informal remedies in interna-

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8. See Abbott & Snidal, *supra* note 2, at 427; Hathaway, *supra* note 1, at 494; Laurence R. Helfer & Anne-Marie Slaughter, *Toward a Theory of Effective Supranational Adjudication*, 107 YALE L.J. 273, 276 (1997) [hereinafter Helfer & Slaughter, *Supranational Adjudication*]; Helfer & Slaughter, *International Tribunals*, *supra* note 2, at 904.

9. It is theoretically possible for a state to violate a treaty but not breach it under these definitions. For instance, if a state were wrongly accused of violating a treaty's substantive terms, then refused to comply with the dispute resolution system, this would be a violation without being a breach. The state would have complied with all of the substantive provisions of the treaty, thus not breaching it, but would have deviated from the second-order rules of the agreement, thereby violating the treaty. While this situation is theoretically possible, it is unlikely to occur in practice because states that have not deviated from any substantive rules are unlikely to resist the jurisdiction of the dispute resolution system. States may undertake such actions in exceptional cases but are unlikely to do so as a common practice.

tional law<sup>10</sup> by explaining how the crowding-out effect is much broader than these authors suggest, affecting a host of international institutions, and not just highly developed courts. Part III provides examples from the World Trade Organization's ("WTO") treaty regime, bilateral investment treaties, and the public responses to states' deviations from these international economic agreements to illustrate how dispute resolution institutions may decrease the reputational costs of breach.

Part IV argues that this choice of a dispute resolution system is often a purposeful effort to limit remedies to the harm caused, and thus to price noncompliance rather than to sanction it. In addition, this Part incorporates discussions of institutional "flexibility" from political science, which highlights how cooperation may become more robust as a self-enforcing equilibrium if it permits more defections.<sup>11</sup> From this view, institutional design features that facilitate treaty breach can enable greater cooperation by permitting more flexible provisions in the negotiation stage and more escape options in the implementation phase.<sup>12</sup> The political science literature has thus far not focused on how these flexibility mechanisms interact with informal sanctions, such as reputation and reciprocity, which is surprising given the heavy emphasis in international relations scholarship on reputation as an enforcement device. This Article attempts to integrate political science literature's focus on flexibility with scholarly work in international law.

Part V concludes by discussing how negotiators may *accidentally* lower the reputational costs of breach by establishing a formal remedy regime. Such a remedy mismatch has significant implications for international law theories of institutional design and optimal remedies. While this Article focuses on international economic agreements, the relationship between remedies and the audience's beliefs about the mandatory nature of substantive treaty rules is an issue for other types of treaties as well. This section discusses the possible implications for human rights treaties and environmental agreements, namely how attempts to "harden" international rules by adding formal remedies may be self-defeating because remedies may lower the reputational costs of breach and, in some cases, may also lower the overall level of enforcement.

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10. See generally SCOTT & STEPHAN, LIMITS OF THE LEVIATHAN, *supra* note 1 (arguing that formal institutions can crowd out reciprocity and reputational effects).

11. The approach of this Article is a positive theoretical approach, not a normative approach. This Article claims that dispute resolution institutions can, and sometimes do, decrease reputational costs to states. The claim is not that lowering reputational costs of defections is beneficial for the international legal system or would improve global welfare. Understanding how reputational mechanisms are likely to work, however, is important for scholars who more directly engage in normative analyses.

12. See generally Alan O. Sykes, *Protectionism as a "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations*, 58 U. CHI. L. REV. 255 (1991) [hereinafter Sykes, *Protectionism as a "Safeguard"*]; B. Peter Rosendorff & Helen V. Milner, *The Optimal Design of International Trade Institutions: Uncertainty and Escape*, 55 INT'L ORG. 829 (2001); Kyle Bagwell & Robert W. Staiger, *Enforcement, Private Political Pressure, and the General Agreement on Tariffs and Trade/World Trade Organization Escape Clause*, 34 J. LEGAL STUD. 471 (2005); GEORGE W. DOWNS & DAVID M. ROCKE, *OPTIMAL IMPERFECTION? DOMESTIC UNCERTAINTY AND INSTITUTIONS IN INTERNATIONAL RELATIONS* 76-104 (1995).

## I. THE CONVENTIONAL ACCOUNT

The relevant reputation generally discussed in international relations and international law scholarship is a “reputation for cooperativeness,” because it is this reputation that treaty partners are interested in when entering into negotiations. As I show below, this literature generally holds the view that compliance with international agreements is the basis for the state’s reputation for cooperativeness. It also embraces the conventional wisdom that dispute resolution institutions will raise the reputational costs to states that breach international law.

The standard model of reputation in international law focuses on the “state’s reputation” and assumes that the state has a single reputation for cooperativeness that encompasses all issue areas.<sup>13</sup> These assumptions (the “unitary state” view and the “unitary reputation” view) concern how the audience perceives the state and how the audience assesses information about the state’s reputation.<sup>14</sup> Scholars who use these assumptions do not necessarily believe that they are true, but argue that these are simplifying assumptions that are appropriate for models of reputational effects.<sup>15</sup>

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13. See generally Abbott & Snidal, *supra* note 2; GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1; Hathaway, *supra* note 1; Raustiala, *supra* note 1; Simmons, *supra* note 1.

14. This Article emphasizes reputation as a perception belonging to the members of the audience, rather than an asset that the state can directly control. The audience can be any observer of the state’s actions. Observers include public actors (such as other governments; political parties, even when not in power; diplomats; members of international organizations; regulators; and judges), as well as private actors (such as corporations, private investors, policy-oriented non-governmental organizations, and voters). Moreover, these audience perceptions can change according to forces beyond the state’s reach. Most international law and international relations scholars acknowledge this collective possession of reputation by the audience, but for ease of exposition, they model reputation as belonging to the state. This Article tries to depart from that simplifying assumption and argues that it is probably most useful to consider the audience as having a range of views, with different agreements having different means and distributions. The view of reputation as belonging to the audience also highlights the psychological aspects of reputation, thus emphasizing the role of perception, beliefs, and cognitive biases in the formation of audience members’ views of a state’s reputation. This approach can further provide hypotheses as to how reputation and dispute resolution institutions will interact in bilateral, multilateral, and public-private relationships.

15. See, e.g., GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1, at 17–19 (articulating and justifying “standard rational choice assumptions”). See generally Timothy J. McKeown, *The Limitations of “Structural” Theories of Commercial Policy*, 40 INT’L ORG., 43–52 (1986) (discussing the broader justifications (and limits) to simplifying assumption in international relations theory). As commentators have argued elsewhere, these assumptions are problematic because they can systematically bias our understanding of how reputation works and dramatically inflate the potential effects of reputation in promoting compliance with international law in a wide range of areas. See generally George Downs & Michael Jones, *Reputation, Compliance, and International Law*, 31 J. LEGAL STUD. S95 (2002); Rachel Brewster, *Unpacking the State’s Reputation*, 50 HARV. INT’L L.J. 231 (2009). Nonetheless, for the purposes of this Article, I accept and use these assumptions. I do so because they represent the strongest possible assumptions for the proposition that dispute resolution systems increase the reputational costs to the state for noncompliance with international rules. I do not mean to suggest that these assumptions are the correct level for modeling reputation. Rather, I am attempting to create the best possible conditions for the prevailing account’s argument and the highest bar for demonstrating that dispute resolution institutions do not always increase the reputational costs to governments/states. If the conventional wisdom that dispute resolution adds to the state’s reputational losses does not hold even with these assumptions incorporated, then they are even less likely to hold with different assumptions, such as attaching the

### A. A Reputation for Cooperativeness

States are interested in forming international agreements that offer benefits to the state and look for treaty partners that could also benefit from cooperation.<sup>16</sup> The fact that a treaty is in both states' mutual interest does not assure compliance with the agreement's rules. A party to the treaty may have an interest in choosing cooperation over the status quo because the gains to the party are greater than in a world without the international agreement, but may nonetheless have an incentive to cheat because it will gain more if it defects while other states comply.<sup>17</sup> All parties understand the underlying strategic situation and its implication that cooperation is beneficial, but that obstacles to cooperation may persist. As a result, states are careful in selecting treaty partners. A state may announce that it plans to abide by a treaty's terms, but potential partners cannot be certain that the state will resist the temptation to cheat on the agreement at a later date.

The state's reputation—the audience's knowledge of its past behavior—provides potential treaty partners with information on the state's future cooperativeness.<sup>18</sup> If the state has cheated on treaties in the past, then other states may assume that the state may be likely to do so again in the future.<sup>19</sup> The audience does not need to understand the domestic reason for the cheating to form an opinion, although such information may be useful.<sup>20</sup> The cause can vary from a scofflaw dictatorial ruler to a gridlocked separation-of-powers system that makes passing the necessary implementing legislation difficult. The audience can apply its knowledge of the government's reputation when deciding whether to include the government in a particular treaty agreement.<sup>21</sup> A government with a poor reputation may be completely ex-

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relevant reputation to particular governmental regimes or officials or limiting the scope of reputation to specific issue areas.

16. See generally KEOHANE, *supra* note 1.

17. See generally Abbott & Snidal, *supra* note 2; GOLDSMITH & POSNER, *supra* note 1.

18. See generally sources cited *supra* note 1; Abbott & Snidal, *supra* note 2, at 427 (noting that the costs of violating a hard law commitment are particularly high because "the reputational effects of a violation can be generalized to all agreements subject to international law").

19. GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1, at 35–36.

20. How much information a prospective partner will gather on the government depends on a number of factors, including the extent of the cooperation and the search costs of obtaining additional information.

21. If a member of the audience has complete information regarding the state's course of action or probability of taking various policy actions, then reputation becomes irrelevant. In such a case, the audience member does not need the additional information that reputation provides and will rationally ignore it. In international relations, audience members rarely, if ever, have complete information on a state's future actions. Thus, reputation is widely believed to be relevant in a broad variety of settings. The informational point, however, remains important. First, to the extent that the state's past actions cease to be predictive of its future actions—for example, because of a change in leadership or in the form of government—then the state's reputation is either discounted or ceases to be pertinent. Second, reputational analysis is not a sanctioning system, and the inclusion of reputation in the audience's analysis is not costly (it is in the audience's interest to incorporate the information that it has about the state to the point where information-related search costs equal the expected benefits of greater information), while imposing sanctions often is. See generally GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1. Third, the audience is not actively trying to reward or punish the state for its past acts in considering the

cluded. Alternatively, a government may be included in the treaty, but its reputation may remain relevant in the treaty negotiations.<sup>22</sup> For instance, if State A abides by its trade concessions ninety percent of the time while State B does so eighty percent of the time, trade concessions by State A will be worth more than those by State B, all else being equal. As a result, reputation is thought to influence state decisionmaking. A state wants to comply with international law today because doing so will expand the state's opportunities to engage in beneficial cooperative activity tomorrow.

It is important to note that a reputation for cooperativeness within the regimes the state has *joined* is the operative reputation.<sup>23</sup> Complying with existing treaty obligations can be a very different matter than being perceived as a good global citizen.<sup>24</sup> For instance, the refusal to take on legal obligations might do much more to influence the popular perception of the state than its breach of legal obligations. The United States' refusal to join the International Criminal Court has almost certainly hurt its reputation as a responsible member of international society. An American government looking to improve the popular image of the United States abroad might do better by committing to the Criminal Court, even if compliance is likely to be less than perfect, than by refusing the legal obligations altogether. Yet, by refusing to take on legal obligations, the United States is arguably enhancing its reputation for compliance within regimes it has joined by declining to sign treaties with which the government does not plan to obey.<sup>25</sup> A reputation for cooperativeness is thought to be critical because it is this reputation that provides information about how a prospective treaty member will act as a member of an agreement.<sup>26</sup> A state's actions in issue areas where it does not have a legal obligation are less informative of the state's future behavior as a treaty partner.

### B. *A Reputation for Cooperativeness and Dispute Resolution Institutions*

The conventional account maintains that dispute resolution heightens the reputational costs to governments of breaching treaty obligations through two mechanisms: (1) providing an independent and authoritative decision

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state's reputation. Past bad (or good) acts that the audience considers irrelevant towards the state's future behavior, whether towards cooperation in general or towards a specific treaty regime, are not incorporated into reputational analysis.

22. Andrew Guzman, *The Design of International Agreements*, 16 EUR. J. INT'L L. 579, 596 (2005) [hereinafter Guzman, *International Agreements*] ("When making a promise, a state pledges its reputation as a form of collateral. A state with a better reputation has more valuable collateral and, therefore, can extract more in exchange for its own promises."); Schwartz & Sykes, *supra* note 1, at S196–97 (discussing how the future value of trade concessions are diminished by breach).

23. See generally GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1; Brewster, *supra* note 15.

24. See Brewster, *supra* note 15. For instance, the phrase "illegal but legitimate" highlights the gap between actions that are widely understood to be good policy and actions that are legally permissible.

25. Edward Swaine, *Reserving*, 31 YALE J. INT'L L. 307, 340 (2006) (discussing this effect with reservations).

26. See generally GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1.

on whether a breach has occurred; and (2) publicizing the announcement of a breach to a wide audience.

First, dispute resolution addresses the “auto-interpretation” problem in international law: without a dispute settlement institution, either ad hoc or permanent, governments are left to make their own decision regarding whether or not a breach of international law has occurred.<sup>27</sup> This involves both an assessment of what event actually occurred and whether that event was in breach of some international obligation.<sup>28</sup> The international system is a noisy informational environment, and various governments may reach different decisions and may have low levels of confidence in their decisions. Formal dispute resolution can provide clearer information to the international audience.<sup>29</sup> Adjudicative bodies can declare their findings of fact as well as their legal analysis of whether a breach of international law has occurred. While the international audience may not strictly believe that the dispute resolution system is always correct in its assessments, a dispute resolution system can at least provide a credible narrative around which the international audience can coalesce.<sup>30</sup> Having a dispute resolution system heightens the reputational costs of cheating to the state because the state cannot credibly maintain that it is not in breach of the treaty and thus cannot rely on the noisiness of the international system to mask its actions.<sup>31</sup>

Second, the decision of the international dispute resolution body is widely and cheaply available to all members of the audience, including non-state actors.<sup>32</sup> The dispute resolution system effectively brands the state as being in breach of international law and broadly advertises this defection.<sup>33</sup> This results in higher reputational losses because more members of the audience are likely to learn about the breach and because the signal from the dispute

27. Abbott & Snidal, *supra* note 2, at 427 (discussing how delegating interpretation of international law rules to a court constrains self-serving interpretations by the respondent state).

28. Posner & Yoo, *Judicial Independence*, *supra* note 1, at 14–22 (discussing how international tribunals can resolve the meaning of the treaty where the parties disagree on the facts or the application of the treaty rules).

29. See Gary Born, *A New Generation of International Adjudication*, 61 DUKE L.J. 775, 782–91 (2012) (summarizing legal scholarship on international adjudication and concluding that advocates and skeptics of international adjudication agree that these institutions provide information to the audience).

30. *Id.*

31. Schwartz & Sykes, *supra* note 1, at 196–98; Bernhard Zangle, *Judicialization Matters! A Comparison of Dispute Settlement Under GATT and the WTO*, 52 INT'L STUD. Q. 825, 827–30 (2008).

32. Milgrom, North & Weingast, *supra* note 1 (discussing how the law merchant institution made information available to trading parties at a reasonable price); Raustiala, *supra* note 1, at 606–13 (discussing how strong review mechanisms disperse information and thereby influence the state's reputation). The signal from the dispute resolution body can be complex if the reader wishes to understand what the legal reasoning was and what parts of the respondent government's measure were judged to be legal.

33. Abbott & Snidal, *supra* note 2; Helfer & Slaughter, *International Tribunals*, *supra* note 2. The publicity aspect can be avoided through institutional design: some dispute resolution systems may be confidential to the parties and thus decrease this function. To the extent that the dispute resolution system is not public, its deterrence function declines. Most discussions of dispute resolution in international law assume that the resolution process is public. This Article accepts this assumption that dispute resolution will be public and argues that, even in that case, dispute resolution systems do not necessarily raise the reputational costs of breach to states.

settlement body is clear.<sup>34</sup> The cheaper and better the information, the more likely the audience will incorporate this information into its reputational assessment of the state.<sup>35</sup>

As a consequence, dispute resolution systems are believed to improve compliance with international law.<sup>36</sup> Because reputation is thought to be relevant to a state's future set of potential cooperative ventures, the loss of reputation can deter states from breaching international agreements. A dispute resolution system can intensify these costs and thereby amplify the deterrent effect.<sup>37</sup>

Dispute resolution may also increase other states' recourse to self-help measures, such as economic sanctions, by reducing the risk of a reputational loss for the sanctioning state.<sup>38</sup> Thompson describes this as the sanctioner's dilemma: a state considering self-help measures may be concerned that its own actions will be considered breaches of international law and that it will face reputational damage.<sup>39</sup> For instance, a state that suspends its adherence to a treaty's obligations in response to what it believes to be another state's breach of that treaty is vulnerable to claims that it is itself breaching international law, if the international audience does not agree that the predicate action was a breach of international law or that the breaching government's action was serious enough to warrant the sanctioning state's reprisal.<sup>40</sup> Dispute settlement institutions are able to clarify when retaliation is warranted. These institutions can clarify whether a breach occurred and, if given the jurisdiction to do so, can authorize a specific level of counter-action by the injured government.<sup>41</sup> So long as the retaliating state stays within the limits set out by the dispute resolution system, the state is unlikely to face reputational harm.<sup>42</sup> This raises the expected costs of deviations of international rules. Because the dispute resolution system protects the sanctioner's reputa-

34. Schwartz & Sykes, *supra* note 1, at 196–98; Helfer & Slaughter, *International Tribunals*, *supra* note 2.

35. Milgrom, North & Weingast, *supra* note 1.

36. See sources cited *supra* note 1.

37. See Guzman, *International Agreements*, *supra* note 22, at 598; Raustiala, *supra* note 1, at 606. See generally GUZMAN, *HOW INTERNATIONAL LAW WORKS*, *supra* note 1.

38. Kenneth Abbott & Duncan Snidal, *Why States Act Through Formal Institutions*, 42 J. CONFLICT RESOL. 3, 27 (1998). See generally Daniel Kono, *Making Anarchy Work: International Legal Institutions and Trade Cooperation*, 69 J. POL. 746 (2006); Alexander Thompson, *The Rational Enforcement of International Law: Solving the Sanctioners' Dilemma*, 1 INT'L THEORY 307 (2009).

39. See Thompson, *supra* note 38.

40. The United States has frequently been accused of acting illegally in its response to other states' alleged breaches of international trade law. See generally Alan O. Sykes, *Constructive Unilateral Threats in International Commercial Relations: The Limited Case for Section 301*, 23 LAW & POL'Y INT'L BUS. 263 (1992) (discussing and arguing against the claim that the United States was overly aggressive in its retaliation); Alan O. Sykes, "Mandatory" Retaliation for Breach of Trade Agreements: Some Thoughts on the Strategic Design of Section 301, 8 B.U. INT'L L.J. 301, 311 (1990) (same).

41. See Schwartz & Sykes, *supra* note 1, at 183–88 (arguing that limiting retaliation is the primary rationale for the WTO dispute settlement system). See also Abbott & Snidal, *supra* note 38, at 27.

42. Thompson, *supra* note 38, at 317–18.

tion, the sanctioning state is more likely to punish breaches of international law.

## II. ROLE OF DISPUTE RESOLUTION INSTITUTIONS IN ESTABLISHING BELIEFS

Against the conventional model outlined in the previous section, this Article argues that breaches of a treaty obligation do not necessarily lead to greater reputational losses for the breaching party relative to a system without dispute resolution. Reputational analysis is a highly contextual decision process and institutions are an important part of this context. Institutions are not only sets of rules, but also sets of beliefs between parties about what constitutes cooperative behavior.<sup>43</sup> Without institutions, either formal or informal, actions cannot inherently be viewed as cooperative or non-cooperative. Even apparent acts of kindness, such as offering foreign aid, can be interpreted positively (as generosity) or negatively (as establishing a dependency relationship).<sup>44</sup> Institutions develop expectations among members concerning future behavior by creating understandings of which future actions will be considered cooperative.<sup>45</sup> In doing so, institutions influence the audience's view of whether existing laws or norms were contravened and what the action implies about the party's future behavior.

This section examines the role of dispute resolution and remedy regimes in clarifying the nature of a treaty obligation. Remedies have important framing effects. Conceived of as a sanction, remedies connote punishment and community disapproval of certain behaviors. Yet remedies that are framed as prices connote permission, even an entitlement, to undertake certain actions. When treaties establish remedy regimes, the treaty designers necessarily engage this framing issue. Similar discussions on the role of remedy regimes exist in debates in American contract law concerning the nature of contractual obligations. Much of that debate divides along disagreements concerning whether contract terms are promises backed by a moral obligation, economic relationships designed to promote the efficient allocation of resources, or something else. As this debate highlights, different framings of the nature of contract obligations result in different views concerning whether breach should be discouraged, tolerated, or facilitated. These different views influence the audience's perceptions about whether breach should have an effect on the deviating party's reputation.

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43. See generally Jack Knight, *INSTITUTIONS AND SOCIAL CONFLICT: POLITICAL ECONOMY OF INSTITUTIONS AND DECISIONS* (1992); DOUGLASS NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990).

44. For a discussion of how generous trade terms can establish a dependence relationship, see Albert O. Hirschman, *NATIONAL POWER AND THE STRUCTURE OF FOREIGN TRADE* (1980).

45. See generally AXELROD, *supra* note 1; KEOHANE, *supra* note 1.

Part IV argues that dispute resolution institutions give the breaching party an opportunity to demonstrate (or not) its compliance with the broader treaty regimes. Unlike domestic law, in which remedies can be enforced by a state with overwhelming coercive force, compliance with remedy rules in the international system is essentially voluntary. The willingness of the state to comply with these rules can establish, at least in part, the state's continued cooperativeness. Where dispute resolution institutions exist, the state's response to the dispute resolution institution's judgment may be more determinative of the reputational effects of the breach than is the judgment itself.

#### A. *Prices Versus Sanctions*

There is a relationship between the nature of a treaty obligation and the remedies the treaty offers in case of breach. Even if the drafters of a treaty do not intend it, the remedies for breach are a statement about the importance of the rule and the notions about the appropriate remedies if the rule is breached. In short, remedies have social meanings.<sup>46</sup> As the legal literature has already recognized, remedies can be conceived of as a sanction—a punishment for undesirable behavior, or a price—a license to engage in behavior at a certain cost.<sup>47</sup> These two functions have very different effects on how the community perceives the action.<sup>48</sup> A sanction is a stigma and re-enforces the informal remedies that the community may employ, such as social or economic isolation, or a loss of reputation.<sup>49</sup> A price is the purchase of permission to engage in a specific action and excludes (or lessens) informal sanctions because prices imply that the actor is entitled to the behavior: she has bought the “right” to act in the socially undesirable way.<sup>50</sup> So long as the price is paid, the formal remedies are exclusive of informal remedies; there are few social implications, and the purchaser does not suffer a reputational loss.

The key question in this analysis then becomes what makes a remedy a price and what makes it a sanction. Fundamentally, the difference between the two is the perception of the audience, but this definition is endogenous to the effects that we are trying to measure.<sup>51</sup> Cooter discusses the difference between prices and sanctions and distinguishes the two based on a variable

46. See generally Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591 (1996) (discussing the differing social meanings of various sanctions); Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943 (1995); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

47. See Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998); See generally Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984).

48. Cooter, *Prices and Sanctions*, *supra* note 47.

49. *Id.*

50. See, e.g., Sunstein, *supra* note 46, at 2045–46 (“Critics claim that emissions trading has damaging effects on social norms by making environmental amenities seem like any other commodity: a good that has a price, to be set through market mechanisms.”).

51. See Kahan, *supra* note 46; Sunstein, *supra* note 46.

exogenous to the audience's perception—the characteristics of the remedy itself.<sup>52</sup> Cooter argues that a charge is a sanction when the remedy is designed to deter the behavior completely, and thus a sanction increases with the length of the breach and is conditional on the breacher's state of mind (whether the breach is intentional).<sup>53</sup> The extent of the sanction is not limited to the damage resulting from the breach but can continue to increase based on the actions and moral fault of the breacher.<sup>54</sup> By contrast, prices are conditional on the harm the activity causes. The goal of a price is not to deter persons from engaging in an activity but to permit the activity when the level of gain is greater than the harm that the activity causes.<sup>55</sup> Thus, whether a remedy is a price is based on the action's consequences, not the level necessary to deter the activity.<sup>56</sup>

Cooter's framework is not perfect. It has the advantage of defining the sanctions and price exogenously from community reaction, but it may not accurately track the social meaning that the audience assigns to the remedy. For instance, it is possible that a fine set at the level of harm that the activity causes (defined as a price in Cooter's framework) will be viewed as a sanction in the sense that the audience sees the fine as a condemnation of the person's actions. For instance, American tort law only permits the recovery of compensation for harms caused by negligence, but the audience may not view negligence, even if compensated, as "purchased." In these cases, informal community sanctions such as shaming, social exclusion, or loss of reputation may apply to the activity.<sup>57</sup> Nonetheless, Cooter's framework seems to be a decent rough guide to prices and sanctions in the sense that the community defines the remedy with social goals in mind. Remedies should track community views of forbidden versus permissible activities in broad strokes, even if the categories are not always perfect. Thus, Cooter's framework is a good starting point for the prices and sanctions distinction, but a reference back to the community reaction, where possible, is important for confirmation.

The difference in the normative forces between prices and sanctions exists at both the level of substantive law and law enforcement. As a matter of substantive regulation, the choice between prices and sanctions is at the forefront in discussions of environmental policy. While economists highlight the market efficiency of pricing pollution by creating tradable per-

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52. Cooter, *Prices and Sanctions*, *supra* note 47, at 1537–38.

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.* See also Kahan, *supra* note 46 (discussing why fines are not shaming and thus an insufficient alternative to imprisonment or other shaming punishments).

57. See generally Robert R. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA L. REV. 1603 (2000) (discussing how the creation of a rule, even without enforcement, can create community costs).

mits,<sup>58</sup> environmentalists are concerned about the social meaning of establishing a price for pollution.<sup>59</sup> Michael Sandel reflects the views of permit skeptics, arguing that,

[T]urning pollution into a commodity to be bought and sold removes the moral stigma that is properly associated with it, if a company or a country is fined for spewing excessive pollutants into the air, the community conveys its judgment that the polluter has done something wrong. A fee, on the other hand, makes pollution just another cost of doing business, like wages, benefits and rent. The distinction between a fine and a fee for despoiling the environment is not one we should give up too easily.<sup>60</sup>

The *form of regulation* itself influences the views of the community with respect to the activity. Pricing the activity can create certain benefits, such as minimizing the cost of pollution control by allowing the firms capable of abating pollution at the lowest cost to decrease pollution the most,<sup>61</sup> but it also alters the community's understanding of the pollution reduction requirement. The requirement to reduce pollution goes from being a shared community responsibility—in which the failure to participate has social costs—to a system in which one no longer has an individual responsibility to reduce pollution, but can simply pay others to do so.<sup>62</sup> The obligation is no longer mandatory, but priced.<sup>63</sup>

Similar discussions regarding the relationship between substantive contract law and remedy rules exist within American scholarship on law enforcement and the obligations imposed by contract. Much of this discussion can be viewed as a disagreement about what the nature of contract obligations and remedies are. Some scholars, such as Charles Fried, argue that the

58. See, e.g., Bruce A. Ackerman & Richard B. Stewart, *Reforming Environmental Law: The Democratic Case for Market Incentives*, 13 COLUM. J. ENVTL. L. 171 (1987); Robert N. Stavins, *A Meaningful U.S. Cap-and-Trade System To Address Climate Change*, 32 HARV. ENVTL. L. REV. 293 (2008); Jonathan Baert Wiener, *Global Environmental Regulation: Instrument Choice in Legal Context*, 108 YALE L.J. 677, 724 (1999).

59. John P. Dwyer, *The Use of Market Incentives in Controlling Air Pollution: California's Marketable Permits Program*, 20 ECOLOGY L.Q. 103, 111 (1993); Yuval Feldman & Doron Teichman, *Are All "Legal Dollars" Created Equal?*, 102 NW. U. L. REV. 223, 234 (2008); Carol M. Rose, *Rethinking Environmental Controls: Management Strategies for Common Resources*, 1991 DUKE L.J. 1, 27, 34; Sunstein, *supra* note 46, at 2045–46 (“Critics claim that emissions trading has damaging effects on social norms by making environmental amenities seem like any other commodity: a good that has a price, to be set through market mechanisms.”); Wiener, *supra* note 58, at 724. *But see* Lior Jacob Strahleivitz, *How Changes in Property Regimes Influence Social Norms: Commodifying California's Carpool Lanes*, 75 IND. L.J. 1231, 1292–93 (2000) (arguing that commodification can bolster some environmental norms).

60. Michael J. Sandel, *It's Immoral to Buy the Right to Pollute*, N.Y. TIMES, Dec. 17, 1997, at A23.

61. Stavins, *supra* note 58.

62. Sandel, *supra* note 60, at A23; Sunstein, *supra* note 46, at 2045; Rose, *supra* note 59, at 34.

63. Robert E. Goodin, *Selling Environmental Indulgences*, 47 KYKLOS 573, 583 (1994) (“A religious indulgence is granted upon condition of the indulged feeling true contrition for their sins. The environmental indulgence may be granted, by the same token, upon condition of the indulged showing that they have no other choice and that they have made good-faith (albeit unsuccessful) efforts to avoid damage to the environment. The objection here in view is not conditionality as such, but rather to making the granting of the indulgence conditional upon payment of hard, cold cash.”).

parties to a contract have made a mutual promise to fulfill the terms of the contract and that they have a moral obligation to stand by that promise.<sup>64</sup> The remedy regime in American contract law, however, does not impose penalties for breach that would incentivize compliance appropriate with a moral obligation to keep a promise.<sup>65</sup> Contract law generally only offers parties expectation damages and imposes an obligation on the breached-upon party to mitigate its damages.<sup>66</sup> If contractual agreements are promises that the parties are morally obligated to fulfill (and the goal of remedies is to incentivize actions consistent with the goals of contract law), then more appropriate remedies would include punitive damages for breach of contract or specific performance, even if we expect parties to bargain for a monetary settlement.<sup>67</sup> Fried acknowledges that the available remedies may not be strong enough to encourage the appropriate level of contract compliance but maintains that the lack of remedies should not undercut the sense of moral obligation in keeping the substantive promise.<sup>68</sup> He argues for the reform of contract rules in some areas, such as the assignment of attorney's fees, but generally supports the current set of contract remedies, including expectation damages and the obligation to mitigate damages, based in part on the moral obligations of the breached-upon party to minimize unnecessary loss.<sup>69</sup>

Other scholars who embrace a moral-agent perspective (if not a contract-as-moral-promise view) are more disturbed by the lack of adequate remedies. Seana Shiffrin argues that the lack of appropriate remedies denigrates promises, fails to provide a legal structure that a morally decent person could accept, and potentially undermines the legal and social culture necessary for democracy.<sup>70</sup> She maintains that the contract law requirement that the breached-upon party mitigate its losses and prohibitions on punitive damages creates conditions that make it impossible for moral agency to flourish, promoting a societal view that gives the benefits of breach to the party in the moral wrong.<sup>71</sup> Thus, for Shiffrin, the nature of the legal obligation and remedies have a tight relationship: the failure of the regime to provide for adequate remedies undermines the nature of the obligation and provides belief among the audience that breach is acceptable.

64. See generally CHARLES FRIED, *CONTRACT AS PROMISE* (2007).

65. See generally Charles Fried, *Contract as Promise: 30 Years Later*, 44 *SUFFOLK U. L. REV.* (forthcoming 2012) [hereinafter Fried, *Promise 30 Years Later*].

66. *Id.* See generally Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 *HARV. L. REV.* 708 (2007).

67. Fried, *Promise 30 Years Later*, *supra* note 65; Shiffrin, *supra* note 66, at 722–27 (arguing that the remedies to contract, if viewed a moral obligation, should include the possibility of punitive damages, specific performance, and attorneys fees).

68. Charles Fried, *The Convergence of Contract and Promise*, 120 *HARV. L. REV.* 1 (2007).

69. *Id.* at 6–9.

70. Shiffrin, *supra* note 66.

71. *Id.*

Alternatively, contract scholars in the law and economics tradition have tended to discount the moral force of a promise between the parties and have focused more on the incomplete nature of contracts.<sup>72</sup> Steven Shavell argues that contracts are mostly incomplete in that they do not include contingencies for most future states of the world.<sup>73</sup> When contract breach occurs, the implicit contingency statement is that the seller should perform unless the costs to the seller are less than the value of the performance to the buyer.<sup>74</sup> Any other rule, such as demanding performance as the default, does not maximize the joint welfare of the parties because it requires the seller to perform at a cost that is greater than the value of the performance to the buyer. Instead, if the seller pays expectation damages, then the joint welfare of the parties is maximized. Because a rule that permits breach if expectation damages are paid produces the greatest joint welfare for the parties and compensates the buyer's injury, Shavell concludes that breach should not be considered immoral.<sup>75</sup> Actual contract remedies are a better fit with this rationale—the breached-upon party receives expectation damages and has an obligation to mitigate its losses—although there are several arguments that expectation damages may not fully compensate the breached-upon party.<sup>76</sup> Under the law and economics rubric, remedy rules encourage optimal compliance with contract rules: compliance when a breach would result in a net loss to the parties, but breach when it produces a net benefit. That a party has the option of breaching when there is a joint economic gain is uncontroversial, and there is not necessarily any social or moral opprobrium with breach.<sup>77</sup>

An alternative way to construct a contract (if not an alternative approach to contractual obligation) is to have the parties make the substance of the contract an option of performance.<sup>78</sup> The parties agree either to perform or

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72. Steven Shavell, *Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts*, 107 MICH. L. REV. 1569 (2009); Steven Shavell, *Is Breach of Contract Immoral?*, 56 EMORY L.J. 439 (2006).

73. Shavell, *Incompleteness of Contracts*, *supra* note 72, at 1571–73.

74. *Id.* at 1572.

75. *Id.* at 1579–80.

76. Fried, *Convergence of Contract*, *supra* note 68, at 6. Shavell and others in the law and economic tradition acknowledge these issues. See Shavell, *Incompleteness of Contracts*, *supra* note 72, at 1575.

77. Compare Shiffrin, *supra* note 66, at 710 (“Morality classifies intentional promissory breach as a wrong that, in addition to requiring compensation, may merit punitive reactions, albeit some minor ones; these may include proportionate expressions of reprobation, distrust, and self-inflicted reproofs, such as guilt.”) with STEVEN SHAVELL, *ECONOMIC ANALYSIS OF LAW* 354 (2004) (“[A]gainst the background of incomplete contracts that parties in fact make] breach is thus not an undesirable act but a desirable, good act from the standpoint of the parties and their true wishes.”). There could be appropriation assigned to the failure to pay expectation damages, however, because such actions would make one party worse off (even if the breach remains Kaldor-Hicks efficient).

78. Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004). Scott and Triantis actually go further than acknowledging that option contracts are a possibility. They argue that the best interpretation of contracts between sophisticated parties is the frame of an option contract even if the contract is not structured specifically that way. *Id.* But see Curtis Bridgeman & John C.P. Goldberg, *Do Promises Distinguish Contract from Tort?*, 44 SUFFOLK U. L. REV. (forthcoming 2012) (noting that even highly sophisticated parties may enter into a contract where they understand performance, not compensation, to be legally binding).

to pay a predetermined amount to forego performance. The choice between performance and payment belongs to the parties. This approach blurs the line between substantive contract terms and damages rules. One could interpret a decision not to perform as a breach and the contractually-specified remedy as the *ex ante* agreed compensation. Yet an equally natural reading of the contract could be that both activities are consistent with the terms of the contract: the decision not to perform is not a breach, but a valid completion of the contract. This reading questions what the first-order obligation entails and broadens the scope of compliance with the contract to include paying the agreed-upon sum. Here, second-order rules merge with first-order rules (although they may remain distinct if the courts refuse to enforce the *ex ante* remedy rules because the monetary option is viewed as punitive).<sup>79</sup> This is a distinction with a difference, though, because it speaks to the agreement the parties have actually made and permits acts of non-performance without an allegation of breach.<sup>80</sup>

In all of these approaches, remedies shape the audience's view of the obligation. The audience's perception of the authority of the obligation will, to some extent, reflect what the institution (here, contract law) says the consequences of the breach should be. Remedies can price noncompliance not only for the breached-upon party but also for the audience. Naturally, the nature of the substantive obligations and the remedies can remain separate, but it can be hard to maintain this distinction when one is well aware of the remedy regimes. Contract law is sequenced such that rules regarding breach (what qualifies as a breach) precede discussions of remedies, yet the knowledge of the remedy rule is available and will influence perceptions of what the nature of the obligation is.<sup>81</sup>

Debates regarding contracts are not so far removed from treaties. Treaties are widely viewed as contracts between governments.<sup>82</sup> The parties are able to select the terms that they prefer, including remedies and exit options.<sup>83</sup> Treaties obligate only those states that choose to sign them, affording parties the ability to refuse to take on legal obligations. As with contracts, the

79. SHAVELL, *supra* note 77.

80. Fried, *Promise 30 Years Later*, *supra* note 65.

81. Taken a step further, limits on remedies may lead judges or adjudicators in other dispute resolution systems to redefine the meaning of contracts or statutes. Daryl Levinson demonstrates how limits on a court's ability to provide a remedy for constitutional deviations may lead judges to redefine the party's rights in a manner that fits the available set of remedies. Daryl Levinson, *Rights Essentialism and Remedial Equilibration*, 99 COLUM. L. REV. 857 (1999). Levinson highlights how limits on remedies can redefine judges' views of protectable rights. This Article focuses on the influence of remedies on the obligatory nature of the treaty regime, and thus on the reputational effects of breach, rather than the possibility that the content of first-order rules could themselves be redefined.

82. Scholars often discuss treaty as a form of contract. See generally GOLDSMITH & POSNER, *THE LIMITS OF INTERNATIONAL LAW*, *supra* note 1; GUZMAN, *HOW INTERNATIONAL LAW WORKS*, *supra* note 1.

83. Laurence Helfer, *Exiting Treaties*, 91 VA. L. REV. 1579 (2005); Barbara Koremenos, Charles Lipson, & Duncan Snidal, *The Rational Design of International Institutions*, 55 INT'L ORG. 761 (2001); Swaine, *supra* note 25; Schwartz & Sykes, *supra* note 1.

treaty regime is an institution whose terms will shape the audience's view of the obligation.

From the point of view of the contracting party's reputation, the traditional view in international law is that all treaty obligations should be considered equally binding.<sup>84</sup> The principle of *pacta sunt servanda* (treaties should be obeyed) applies to all treaty obligations and generally matches the "contract as a promise" approach.<sup>85</sup> Thus a party to a treaty who breaches any treaty agreement demonstrates a lack of respect for promises, which carries across all treaty agreements.<sup>86</sup> As result, the traditional view is that breach in one issue area damages the party's reputation for cooperativeness in many, or all, issue areas.<sup>87</sup>

Treaties have historically not included remedies as part of the treaty text, although many prominent treaty regimes now do. The entry of remedy regimes, as part and parcel of broader dispute resolution institutions, will affect the audience's perception of the nature of the treaty obligation and the reputational consequences of breach. This relationship can increase or decrease the audience's perception of the mandatory nature of a treaty's obligations. The argument of this Article is not that dispute resolution institutions always lessen the reputational costs of treaty breach. A remedy regime that provides for both compensatory and punitive damages can reinforce the idea that the treaty obligation is a promise that should not be breached.<sup>88</sup> Dispute resolution institutions may impose sanctions (not prices), and thus reinforce the audience's beliefs regarding the mandatory nature of the related treaty obligations.<sup>89</sup> In these cases, remedies may actually increase the reputational costs of breach to the non-compliant party.

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84. Some rules of international law may be more binding because they have become *jus cogens* norms of international law, but this greater legal obligation derives from the *jus cogens* status not from the legal obligations status as treaty law.

85. Eric Posner and Alan Sykes have recently argued that all treaties *should* be viewed under the efficient breach lens. Alan O. Sykes & Eric A. Posner, *Efficient Breach in International Law: Optimal Remedies, "Legalized Noncompliance," and Related Issues* 110 MICH. L. REV. 243 (2011). This Article does not take a normative view of what the nature of treaty obligations should be. Rather, this Article explores how the creation of dispute resolution institutions will likely influence the audience's beliefs of the nature of the obligations. This will depend, at least in part, on the broader legal context of the rule included in the remedy regime. The audience's understanding of whether the obligation is a normative promise that cannot be broken or a political deal that can be cured through compensation will then influence views of whether breach, in and of itself, is noncooperative and resulting in reputational loss.

86. For a critique of the view that breach necessarily means a lack of respect for law, see Brewster, *supra* note 15; JONATHAN MERCER, REPUTATION IN INTERNATIONAL POLITICS (2010).

87. See generally Abbott & Snidal, *supra* note 2; GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1. For a critique of the view that reputation carries across issue areas, see Downs & Jones, *supra* note 15.

88. The general prohibition of punitive damages in contract law would not apply at the international level. The parties can reach whatever terms they like and certainly can set the damages for breach at a level that deters breach.

89. *But see* SCOTT & STEPHAN, THE LIMITS OF THE LEVIATHAN, *supra* note 1; Scott & Stephan, *Self-Enforcing Agreements*, *supra* note 1.

In some cases, dispute resolution regimes may lower the reputational costs of treaty breach to states. Where treaty agreements set the remedies for breach at compensation, the treaty negotiators recognize that the costs of breach will sometimes be less than the breaching party's gain from the treaty deviation. If the remedy is not to deter or punish breach, but to compensate those injured by the breach, then this becomes part of the audience's beliefs concerning the political deal embodied by the treaty. The remedy regime itself represents the parties' view of the treaty—the parties do not wish to deter a breach of the agreement's obligations in each and every circumstance. The parties may prefer compliance, but only up to a certain point—the point at which the costs of deviation (set out by the remedy regime) outweigh the benefits of the deviation.

Such a remedy regime will influence the audience's view of the mandatory nature of the treaty's substantive obligations. In these cases, the audience may see noncompliance as priced into the treaty. Alternatively, the audience may believe that treaties with their own remedy regimes function as option contracts. This goes to the heart of the question of what states have agreed to when they sign treaties. Have they promised to adopt policies that conform to the policy terms of the treaty, or have they only promised to provide a set level of compensation? Compliance may still be preferred, but the audience's view of the compulsory nature of the treaty's substantive obligations will be influenced by the remedy regime.

Where remedies are compensatory, rather than deterring, a dispute resolution system may lower the reputational costs of deviations to the breaching state. There may be some reputational loss to the state from breach where the remedy regime seems to permit breach, or at least where the remedy is not set at a level that would deter breach. Breach may still be perceived as less cooperative than compliance, even if the breaching party abides by the remedy rules. But the argument here is that reputational costs are lower in these cases than if the treaty did not have a dispute settlement institution. The reputational costs of breaching a treaty are lower if the treaty includes a dispute resolution system and compensatory remedies than if the treaty does not include them.<sup>90</sup>

### A. *Crowding Out Informal Remedies*

Feedback effects between the creation of formal remedies and parties' beliefs about the binding effect of rules can be observed in studies of how penalties alter the audience's perception of the original agreement. The increasingly robust literature on "crowding out" discusses how imposing formal sanctions can have a negative effect on the application of informal

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90. The opposite effect can also occur: if the dispute settlement system has "high" remedies that eliminate any gain from breach or include punitive damages, then the reputational costs of breach may also be higher. In these cases, dispute resolution institutions may better deter breaches.

sanctions.<sup>91</sup> Bruno Frey and others have demonstrated that the addition of formal remedies can lead the audience to rely on these remedies exclusively, and thereby decrease the use of informal remedies, such as reputation and reciprocity. This literature highlights how external motivation can influence intrinsic motivation. For instance, adding a monetary reward for an activity can *reduce* a population's willingness to engage in the activity.<sup>92</sup>

This is true for monetary punishments as well. Even if there are very few formal consequences to breach (as there have traditionally been in international law), the addition of a formal punishment such as a monetary punishment can decrease compliance with the rule rather than raise it. In their study of the behavior of the parents of children attending ten daycare centers in Israel, Uri Gneezy and Aldo Rustichini found that the imposition of a monetary fine actually increased the number of breaches observed, in comparison to the initial situation of no fines.<sup>93</sup> In their study, Gneezy and Rustichini observed the incidence of parents picking up their children after the centers' hours of operation had ended for the day. Parents were occasionally late in retrieving their children, but incidences of lateness were low, with about ten late parents per week per daycare center (each center had an average of thirty-three children). There was initially no fine or other formal sanction for a late pick-up. As directed by Gneezy and Rustichini, six of the daycare centers established a system of fines to be levied when parents failed to pick up their children on time. The number of incidences of late pick-ups rose at these centers to about twenty late pick-ups per week. In contrast, there was not a significant change in the control group of the four daycare centers that continued not to impose any fines.

The conclusion of this study is that parents made use of the system of fines to increase the hours of childcare available to them. The fines were clearly not sufficiently high to achieve the goal of decreasing the rate of late pick-ups. That the rate of late pick-ups *increased* after the system of fines was imposed suggests that formal rules decreased the pre-existing informal sanctions for lateness. Under the previous system, parents did not pay fines even though they bore certain informal sanctions, such as guilt for imposing a burden on the daycare center's personnel and perhaps a reputational loss with the daycare center. If the fines simply reflected an additional penalty

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91. See Iris Bohnet, Bruno S. Frey & Steffen Huck, *More Order with Less Law: On Contract Enforcement, Trust, and Crowding*, 95 AM. POL. SCI. REV. 131, 132 (2001); Bruno S. Frey & Felix Oberholzer-Gee, *The Costs of Price Incentives: An Empirical Analysis of Motivation Crowding Out*, 87 AM. ECON. REV. 746, 747 (1997); Peter H. Huang & Ho-Mou Wu, *More Order Without More Law: A Theory of Social Norms and Organizational Cultures*, 20 J.L. & ECON. 390, 391 (1994); Bruno S. Frey, *A Constitution for Knaves Crowds out Civic Virtues*, 107 ECON. J. 1043, 1044 (1997); Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 29 J. LEGAL STUD. 1, 1 (2000).

92. Frey & Oberholzer-Gee, *supra* note 91, at 747–50 (discussing how residents were less willing to accept a waste dump in their community when they were offered monetary compensation); for a survey of similar studies, see Edward Deci, Richard Koestner & Richard Ryan, *A Meta-Analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation*, 125 PSYCH. BULL. 627 (1999).

93. Gneezy & Rustichini, *supra* note 91, at 1.

added to the penalties of informal sanctions, then the overall level of penalties for late pick-ups should have increased, and the rate of parent breach should have decreased. The fact that the rate of parent breach increased suggests (but does not conclusively prove) that the actual level of penalties decreased with the imposition of the fine. Once the parents were required to pay a fine, some of the parents (though not necessarily all of the parents) faced lower actual sanctions, and thus breached more frequently. Although we cannot know what the parents' decisionmaking process was, the most intuitive explanation is that some of the parents altered their beliefs about how "mandatory" it was to pick up their children on time. The obligation was less binding because they had the option to "pay for" deviations from the rule.<sup>94</sup> If the rule was not mandatory, then the informal sanctions decreased as well. Parents may have expected a lower reputational loss with the daycare center and may have felt less guilt about being late. This study suggests that there is a feedback effect between the imposition of remedies, understandings of the rule, and the effectiveness of informal sanctions in promoting compliance. The imposition of formal sanctions revised the parents' understanding of the daycare center's policy, undermined the system of informal sanctions, and, at least at the level of fines used in the experiment, resulted in a lower overall level of sanctions from the perspective of the parents.<sup>95</sup>

The crowding out literature speaks directly to the design of remedies even at the international level. Iris Bohnet, Bruno Frey, and Steffen Huck argue that, with regard to legal rules, having "medium levels of enforcement"—some formal remedies, but at levels insufficient to deter breach—is the worst possible outcome in terms of compliance.<sup>96</sup> In an experimental setting, the authors found that when there was no formal enforcement of an agreement, participants relied heavily on informal remedies to enforce contracts. The participants were careful in choosing partners and thus formed more contracts with other participants with a preference for keeping

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94. It is also consistent with economic and legal analyses of the commodification of certain public-regarding actions. Public organizations, such as the Red Cross (which receives blood donations) or groups encouraging organ donation, often resist efforts to offer financial compensation for donations. There are many concerns with financial compensation for these types of donations, including the exploitation of the poor. But one major concern is a decrease in the level of donations from individuals who do not need such compensation. See generally RICHARD M. TITMUS, *THE GIFT RELATIONSHIP* (1970). So long as blood or organ donations are viewed as altruistic, the donor (or the donor's family) receives some psychic benefits from the gift. If the donation were given a price, this could actually decrease the number of donations, since the formal benefits, or the price for the donations, would reduce the informal benefits to the point where the overall benefit of donation would be lower for many members of the population. This could occur because the individuals considering making donations (or at least some of them) would alter their beliefs regarding the benefits of the action.

95. In another interesting twist, the experiment removed the system of fines to see if the incidence of parent breaches would return to the earlier level. The level of breach remained at the higher level that existed under the system of fines. One interpretation of this result is that once parents altered their beliefs regarding the existence of informal sanctions, these beliefs were difficult to shift back. Other interpretations are obviously viable as well. Gneezy & Rustichini, *supra* note 91, at 8.

96. Bohnet, Frey & Huck, *supra* note 91, at 138–42.

promises. When formal sanctions were available, parties substantially decreased their use of informal remedies and relied instead upon the remedies provided by the legal system. This did not result in a lower rate of contract performance so long as remedies were high enough to deter defection. Where remedies were set at a medium level, however, the rate of contract breach increased.<sup>97</sup> The formal remedies crowded out the informal remedies as participants put their trust in the legal system rather than screening the other participants.<sup>98</sup> The decline of informal remedies led to an increase in the incidence of breach because the formal remedies were not sufficient to support cooperation with this pool of contracting parties. Thus, the authors argue that “[t]he worst legal regime is not one in which contracts cannot be enforced but one with an intermediate level of enforceability.”<sup>99</sup>

While the authors do not use the term “reputation” to describe the informal remedies, their description of how participants look for signals of trustworthiness in other participants matches the informational function of reputation. The hardening of enforcement mechanisms by establishing formal adjudication or explicit remedies does not necessarily prove additive to informal reputational enforcement mechanisms. Instead, formal remedies may crowd out the use of reputational mechanisms, leading to lower contract performance under certain formal remedy regimes.

International law studies have generally ignored the possibility of formal remedies crowding out informal remedies. The primary exception is Robert Scott and Paul Stephan, who argue that the creation of courts with formal enforcement power decreases the state’s reliance on reciprocity and reputation.<sup>100</sup> Scott and Stephan argue that the growth of a specific kind of international dispute resolution crowds out the effects of reciprocity and reputation in international law. The dispute resolution systems that the authors discuss are institutions that have two characteristics: broad standing rules, including standing for individuals as well as states, and the capacity to assign and enforce remedies on their own. Scott and Stephan argue that these institutions, which are often, but not exclusively, domestic courts, can decrease parties’ willingness to act in a good-faith manner with one another. Instead, the parties rely on the court system and are less vested in their own relationship.

The authors highlight that the move to such formal dispute resolution systems can be less efficient than a system of informal dispute resolution. To the extent that the parties can monitor and enforce the agreement on their own, an informal system is both cheaper (not requiring a legal system) and more accurate (relying on observable rather than verifiable information). Yet

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97. *Id.*

98. *Id.* at 136.

99. *Id.*

100. SCOTT & STEPHAN, THE LIMITS OF THE LEVIATHAN, *supra* note 1, at 4; Scott & Stephan, *Self-Enforcing Agreements*, *supra* note 1, at 554.

there are circumstances where an informal enforcement system will not be effective and a formal system is necessary to support the agreement. Where the agreement involves significant sunk costs by one party or where the information needed to detect defections from the agreements is hard to observe, then the parties will need to create a dispute resolution system to address these hurdles to cooperation.

Scott and Stephan's argument is both positive and normative. They argue that the situations in which we observe such formal dispute resolution systems match these conditions. Thus, governments have implicitly recognized that formal dispute resolution is only necessary in certain issue areas and have made use of formal dispute resolution systems only when the correct circumstances exist. Normatively, they argue that efforts to increase or decrease the legalization of international law in all areas is counterproductive because it can result in sub-optimal enforcement regimes in many areas. If informal dispute resolution can provide cheaper and more accurate resolution of parties' disputes, then efforts to establish formal dispute resolution systems will lead to worse conditions for cooperation. At the same time, scholars who oppose the creation of international courts with broad standing rules and independent remedial power in all (or most) situations fail to recognize the functional benefits of establishing these institutions.

This Article builds on Scott and Stephan's novel application of the crowding out literature and expands the theoretical range of this phenomenon in international law. Scott and Stephan's work can be framed as an example of a much larger understanding of how informal and formal remedies interact in a highly formalized legal system. This Article broadens this view by demonstrating that the interaction between formal and informal remedies is influenced by a host of design elements. The relationship between the design of the treaty and informal sanctions is multifaceted. It encompasses the substantive provisions of a treaty agreement (the form of the treaty's regulation) and the structure of formal remedies, not just the structure of the legal system.

This Article also explores why Scott and Stephan's view that formal dispute resolution will always crowd out informal remedies may be overly pessimistic. If the remedies are structured as sanctions, rather than prices, formal dispute resolution may be able to "crowd in" reputational costs (if not reciprocity), even if administered through a highly formalized legal system. In addition, the analysis of formal and informal remedies need not be limited to institutions with broad standing rules and the ability to impose their own remedies—a definition that excludes many of the most important dispute resolution systems. Rather, this approach to enforcement is relevant to any system that has formal remedies. This Article provides a framework for this analysis and expands the range of international enforcement systems Scott and Stephan discuss to the far larger universe of treaties and international interactions.

### III. FORMAL REMEDIES IN INTERNATIONAL ECONOMIC LAW

Dispute resolution systems do not need to include explicit remedy regimes. Governments designing a dispute resolution institution can opt to include a remedy element, clarifying what consequences come from breach or continued breach, or they can remain silent on the question of remedies.<sup>101</sup> Some international agreements include explicit remedy regimes.<sup>102</sup> The Dispute Settlement Understanding (“DSU”) in the WTO details what remedies are available in the case of breach.<sup>103</sup> Most of the hundreds of bilateral investment treaty regimes include agreements that provide the opportunity for monetary damages and rules for calculating those damages.<sup>104</sup> Human rights treaties also sometimes include explicit remedy provisions. The treaty creating the Inter-American Human Rights Court provides the Court with the authority to award remedies to complaining parties against respondent governments. Tribunals may also develop their own jurisprudence on remedies. The European Court of Human Rights (“ECHR”) has treaty authority to award remedies, but has also developed its own doctrines concerning the types of remedies to be awarded.<sup>105</sup>

This section examines the interaction between formal sanctions and reputational concerns in international economic agreements. This section first discusses the WTO’s dispute resolution system and then considers bilateral investment treaties. In both cases, the remedy regimes are prices rather than sanctions under Cooter’s framework. This section examines how a state’s willingness to pay damages alters the audience’s perception of its cooperativeness with the economic regime.

#### A. *Dispute Resolution at the WTO*

The WTO has perhaps the most well-known dispute resolution process. The WTO Agreements include the DSU, which provides the dispute settlement system with compulsory jurisdiction over all WTO complaints (only states can bring complaints) and the authority to interpret the WTO Agree-

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101. See Henrik Horn & Petros Mavroidis, *Remedies in the WTO Dispute Settlement System and Developing Country Interests*, Report Commissioned by the World Bank 7 (1999), available at <http://www.econ-law.se/Papers/Remedies%20990611-1.pdf> (noting that “[t]he absence of explicit remedies in treaties] is not an anomaly. It is often the case that drafters of a treaty leave to the discretion of the adjudicating body to recommend the appropriate remedy”).

102. Born, *supra* note 29, at 819–67 (detailing the growth of international adjudication institutions, particularly in international economic law).

103. Petros C. Mavroidis, *Remedies in the WTO Legal System: Between a Rock and a Hard Place*, 11 EUR. J. INT’L L. 763, 763 (2000).

104. Jason Webb Yackee, *Pacta Sunt Servanda and State Promises to Foreign Investors Before Bilateral Investment Treaties: Myth and Reality*, 32 FORDHAM INT’L L.J. 1550, 1551–52 (2009).

105. Laurence R. Helfer, *Redesigning the European Court of Human Rights: Embeddedness as a Deep Structural Principle of the European Human Rights Regime*, 19 EUR. J. INT’L L. 125, 128 (2008).

ments.<sup>106</sup> The DSU also provides a set of explicit remedies. If a state breaches a WTO obligation and does not come into compliance within a reasonable period of time after the ruling, then the complaining state can impose its own trade barriers on the breaching state up to the level of the complaining state's current injury.<sup>107</sup> The formal remedy alone is not sufficient to deter deviations—the remedy does not necessarily eliminate the state's gains from the breach. Rather, the remedy seems a rough approximation of American contract law's remedy regime—providing the breached-upon state with the power to raise its own barriers to trade only to the extent that it has lost access to the foreign market. WTO remedies differ from those of American contract law, however, in that they do not provide any remedy for the harm caused by breach if the respondent state decides to “perform” by altering its policies to comply with the regime.<sup>108</sup>

The DSU underscores that the purpose of the dispute settlement mechanism is to resolve disputes, not necessarily to effect compliance with trade rules.<sup>109</sup> The dispute resolution system states a preference for mutually agreeable settlements that are “consistent with the [WTO] agreements,” but clearly leaves room for mutually agreeable solutions that are not.<sup>110</sup> Indeed, before a member brings a case for the breach of trade rules, the agreement counsels that the state should not just consider the legal merits of the case, but also “exercise its judgment as to whether action under [dispute resolution] procedures would be fruitful.”<sup>111</sup>

### 1. *The Structure of the Remedy*

Under the Cooter framework, the WTO system is a pricing system rather than a sanctioning system because it assigns a remedy based on the level of harm rather than the level of sanctions needed for deterrence.<sup>112</sup> Where parties cannot reach a mutually acceptable resolution of a dispute on their own, the WTO system provides for third-party adjudication of the dispute.<sup>113</sup> If the respondent state is found to be in breach of trade rules, the DSU system establishes a preference for compliance with the legal ruling, but provides remedies if compliance is not forthcoming. If the respondent state fails to

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106. Understanding on Rules and Procedures Governing the Settlement of Disputes art. 1.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401 [hereinafter WTO DSU] (stating that dispute settlement rules apply to any dispute between members concerning their rights and obligations under the WTO agreement); WTO DSU art. 3.1 (affirming the members' agreement to adhere to the rules of the DSU).

107. Schwartz & Sykes, *supra* note 1, at S180–81.

108. Rachel Brewster, *The Remedy Gap: Institutional Design, Retaliation, and Trade Law Enforcement*, 80 GEO. WASH. L. REV. 102, 109–11 (2011) [hereinafter *Remedy Gap*].

109. The DSU explicitly identifies the “aim of dispute settlement mechanism is to secure a positive solution to a dispute.”

110. *Id.*

111. *Id.*

112. Cooter, *Prices and Sanctions*, *supra* note 47.

113. WTO DSU arts. 4.7, 6.

withdraw the measure that breaches trade rules, the complaining state can suspend trade concessions to a level “equivalent to the level of the nullification or impairment [from the trade violation].”<sup>114</sup> The remedy is static as to the level of harm: the remedy award does not increase if the respondent state fails to comply or if the respondent state intended to breach international trade rules. Punitive damages are never permitted.<sup>115</sup>

The WTO arbitration panels, which are responsible for calculating the level of the suspension of concessions, have similarly embraced the level-of-harm view of trade remedies, rather than the deterrence view. The calculation of the suspension award is based on the trade flows lost to the complaining state, not the benefits to the respondent state.<sup>116</sup> In addition, the panels have explicitly rejected the idea that the suspension of concessions should be calibrated to the level necessary to secure compliance.<sup>117</sup> For instance, in the arbitration between the United States and the European Communities regarding compliance with the WTO’s *Bananas* decision, the panel highlighted that, while the purpose of the suspension of trade concessions was to induce compliance, “this purpose does not mean that the [Dispute Settlement Body] should grant authorization to suspend concessions beyond what is *equivalent* to the level of nullification or impairment.”<sup>118</sup> The panel further determined that punitive damages were similarly unavailable as a remedy under the WTO system.<sup>119</sup> The WTO system works effectively like a contract law system, providing damages to make the injured party whole, but the remedies are, in many cases, insufficient to eliminate the gains from breach.

In addition, the DSU specifically requires that the dispute resolution system be exclusive of some informal remedies. States cannot act reciprocally in international trade—engaging in tit-for-tat behavior—outside of the WTO dispute resolution system. To engage in any in-kind actions, states must proceed through the DSU system, limiting any reciprocal actions to those specifically authorized by the WTO Dispute Settlement Body.<sup>120</sup> The WTO dispute resolution system has taken a narrow view of even otherwise *legal* actions that are reciprocal actions for suspected breaches of trade rules. In *European Communities—Measures Affecting Trade in Commercial Vessels*, a WTO

114. WTO DSU art. 22.4 (“The level of the suspension of concessions or other obligations authorized by the [Dispute Settlement Body] shall be equivalent to the level of the nullification or impairment.”).

115. Horn & Mavroidis, *supra* note 101, at 22.

116. See, e.g., Panel Report, *United States—Subsidies on Upland Cotton*, WT/DS267/ARB1 & WT/DS267/ARB2 (Aug. 31, 2009).

117. See also David Palmeter & Stanimir A. Alexandrov, “Inducing Compliance” in *WTO Dispute Settlement*, in *THE POLITICAL ECONOMY OF INTERNATIONAL TRADE LAW: ESSAYS IN HONOR OF ROBERT E. HUDEC* 646, 646–47 (Daniel L.M. Kennedy & James D. Southwick eds., 2002); Andrew Mitchell, *Proportionality and Remedies Under WTO Law*, 17 EUR. J. OF INT’L L. 985, 999 (2006).

118. Panel Report, *European Communities—Regime for the Sale, Importation and Distribution of Bananas—Recourse to Arbitration by the European Communities under Article 22.6 of the DSU*, ¶ 6.3, WT/DS27/ARB/ECU (Mar. 24, 2000).

119. *Id.*

120. WTO DSU art. 23.

panel examined whether an allowable subsidy offer by the European Union (“EU”) was a breach of trade rules because the subsidy was adopted in response to an alleged South Korean breach of trade law.<sup>121</sup> The panel found that the EU actions were contrary to trade rules, even if they were otherwise legal as a subsidy, because such actions were an attempt to enforce trade rule outside of the DSU system.<sup>122</sup> In so doing, the panel interpreted the WTO Agreement as condemning any attempts by member states to use in-kind reciprocity as an addition to the formal remedies offered by the DSU.

Whether the fundamental legal obligation of the WTO regime is compliance with the treaty’s substantive rules or is a contract law-type system is the basis for the disagreement between John Jackson, on the one hand, and Warren Schwartz and Alan Sykes, on the other.<sup>123</sup> Jackson argues that governments have a legal obligation under the DSU to comply with the WTO’s substantive obligations.<sup>124</sup> For him, the remedies established by the DSU are not an alternative to compliance, but are penalties levied if legal obligations are not satisfied.<sup>125</sup> Schwartz and Sykes argue that governments’ obligations are more passive and extend only as far as accepting the rebalance of trade concessions if a government opts not to comply.<sup>126</sup> Notably, they rely in part on the nature of the remedies to support their position. They argue that the structure of the agreement is itself conclusive: “[w]e simply note that the provisions of the DSU, taken as a whole, allow a violator to continue a violation in perpetuity, as long as it compensates or is willing to bear the costs of the retaliatory suspension of concessions.”<sup>127</sup>

Much of this debate can be reduced to a question of whether the WTO permits governments to escape from their obligations. The idea of an escape clause is already commonly used to explain the WTO’s Safeguard Agreement.<sup>128</sup> This idea, as formulated by legal scholars and political scientists, is

121. Panel Report, *European Communities—Measures Affecting Trade in Commercial Vessels*, WT/DS301/R (June 20, 2005).

122. *Id.* ¶¶ 7.187–216.

123. Judith Hippler Bello, *The WTO Dispute Settlement Understanding: Less is More*, 90 AM. J. INT’L L. 416, 416 (1996); John H. Jackson, *The WTO Dispute Settlement Understanding—Misunderstanding on the Nature of Legal Obligation*, 91 AM. J. INT’L L. 60, 60–61 (1997); Alan O. Sykes, *The Remedy for Breach of Obligations under the WTO Dispute Settlement Understanding: Damages or Specific Performance?*, in *NEW DIRECTIONS IN INTERNATIONAL ECONOMIC LAW: ESSAYS IN HONOUR OF JOHN H. JACKSON*, 347–57 (Marco Bronckers & Reinhard Quick eds., 2000).

124. Jackson, *supra* note 123, at 60–61.

125. *Id.* at 61.

126. Schwartz & Sykes, *supra* note 1, at S181. See also Bello, *supra* note 123; Sykes, *supra* note 123.

127. Schwartz & Sykes, *supra* note 1, at S191. This raises the interesting possibility that the treaty designers may purposely devise formal remedies to be too low to deter breach, relying on reputational losses to supplement the formal sanctions and thus raise the overall level of sanctions to the appropriate level. In choosing lower sanctions, however, the treaty designers may undermine the reputational costs of breach. Treaty members and the larger international audience may understand the treaty differently and view the low sanctions as a statement that the treaty’s provisions are not intended to be mandatory.

128. See, e.g., Sykes, *Protectionism as a “Safeguard,” supra* note 12; Rosendorff & Milner, *supra* note 12; see also Krzysztof J. Pelc, *Seeking Escape: Escape Clauses in International Trade Agreements*, 53 INT’L STUD. Q. 349, 349 (2009).

that the parties to an agreement will recognize in negotiations that there will be certain situations in which governments will wish to deviate from the Agreement.<sup>129</sup> The Safeguard Agreement sets out the conditions for these deviations *ex ante*. Dispute resolution, in contrast, can function as an *ex post* escape clause.<sup>130</sup> For instance, the WTO's DSU does not attempt to detail *ex ante* the situations under which states are explicitly permitted to deviate from trade rules, but instead assigns a certain penalty when they do. The goal of this paper is not to resolve this debate but to emphasize how dispute resolution institutions can alter the beliefs of some or all members of the audience. If there is reasonable disagreement over whether the DSU permits escape, then at least some international actors will alter their expectations about what set of actions qualify as "cooperative" if the state follows the WTO's remedy regime.

## 2. *Community Response to the Use of WTO Remedies*

In addition to the structure of the remedy, we can observe the audience's response to WTO remedies. The international trade system does not often resort to the use of formal remedies. Less than a dozen cases have actually resulted in the WTO-authorized suspension of trade concessions.<sup>131</sup> Yet the available remedies inform much of the bargaining that takes place regarding compliance. Parties regularly bargain to mutually agreed resolutions of disputes that are less than full compliance.<sup>132</sup>

Most relevant to the question of informal sanctions is how the other member states respond to the use of formal sanctions. Is the suspension of concessions a complement or a substitute for informal sanction? This analysis goes beyond Cooter's framework and attempts to gauge the audience's reaction directly. Determining audience reaction is difficult, as we cannot directly observe how the views of members of the trade community change after a dispute, but member states' public reactions to the use of formal remedies can be illuminating. In a sanctioning regime, we would expect that a dispute would lead to greater community costs. A successful case would encourage other nations to similarly condemn the breaching state's actions and restrict their dealings with the breaching state. If the respondent state continued to refuse to comply with the ruling, the informal sanctions on the breaching state would increase. By contrast, a pricing regime would limit the community response to the formal remedy offered to the com-

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129. Sykes, *Protectionism as a "Safeguard"*, *supra* note 12, at 258–259; Rosendorff & Milner, *supra* note 12, at 829; *see also* Krzysztof, *supra* note 128.

130. *See* Brewster, *Remedy Gap*, *supra* note 108, at 125–27.

131. William Davey, *Implementation in WTO Dispute Settlement: An Introduction to the Problems and Possible Solutions*, RIETI Discussion Paper Series 05-E-013 (2005), at 12 (discussing the infrequent use of sanctions in the implementation of WTO dispute settlement reports).

132. *See generally* Davey, *supra* note 131 (addressing case studies in which parties engage in bargaining for the settlement of disputes).

plaining party. Continued refusal to comply with the trade rule would not lead to escalating informal sanctions.

In most cases, WTO remedies function as a price regime approach would predict. The trade remedies act as parameters within which parties may bargain over levels of compensation. Once the parties reach an agreement based on those parameters, the case is considered concluded even if compliance is not forthcoming. Furthermore, the continued existence of a breach of trade rules does not result in additional litigation by other parties who would have standing to bring a claim. The lack of additional litigation by third parties is particularly interesting because there is not an explicit settlement of the claim with regard to these states.

For instance, in the *European Communities—Hormones* case, the United States and Canada brought a complaint against the EU based on its ban on the import of beef treated with growth hormones.<sup>133</sup> The panel and WTO Appellate Body found that this ban was a breach of international trade rules, largely because of the lack of scientific evidence supporting the European claim that the meat posed a hazard to human health.<sup>134</sup> The EU refused to remove the ban, and the WTO authorized the United States and Canada to suspend trade concessions equaling USD 116 million and CAD 11.3 million, respectively.<sup>135</sup> The United States and Canada did suspend concessions but ultimately reached an agreement with the EU that permitted the hormone ban to remain in place.<sup>136</sup> The EU offered both states additional duty-free access for non-hormone-treated beef and the parties notified the WTO that they had reached a mutually acceptable settlement.<sup>137</sup> The parties are treating the matter as final even though the illegal measure remains in place. Other members of the WTO also seem to accept the settlement as final. No other beef producing states have brought a claim against the EU, including Australia and New Zealand, who were third parties to the original case.

Some WTO disputes are truly priced in the sense that they are resolved through an exchange of cash. In *United States—Section 110(5) of the U.S. Copyright Act*, the European Communities filed a complaint regarding the United States' failure to require the payment of royalties for music played in some commercial venues.<sup>138</sup> The European Communities alleged that the breach was due to an exemption in the U.S. copyright law, which made U.S. law inconsistent with the WTO's Trade Related Intellectual Property

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133. Appellate Body Report, *European Communities—Measures Concerning Meat and Meat Products (Hormones)*, WT/DS48/AB/R (Jan. 16, 1998).

134. *Id.*

135. Daniel Pruzin, *EU, Canada Announce Provisional Deal to End Dispute on Hormone-Treated Beef*, BNA WTO Reporter, Mar. 22, 2011.

136. *Id.*

137. *Id.*

138. Panel Report, *United States—Section 110(5) of the US Copyright Act*, WT/DS160/R (June 15, 2000).

Agreement.<sup>139</sup> Five states—Japan, Canada, Australia, Brazil, and Switzerland—joined the dispute as third parties.<sup>140</sup> The panel that heard the case found in favor of the European Communities, and the United States decided not to appeal the decision.<sup>141</sup> Instead, the United States agreed to arbitrate the amount of the injury to the European Communities from the breach.<sup>142</sup> The arbitration panel found that the European losses from the American breach were EUR 1.2 million annually.<sup>143</sup> Bargaining around that figure, the United States and the European Communities agreed to a payment of USD 3.3 million over three years to resolve the dispute, and the parties notified the WTO that they had a mutually acceptable temporary resolution.<sup>144</sup> The United States has not made any additional payments after the three years and has not altered Section 110(5) of the U.S. Copyright Act to cure the breach of trade rules.<sup>145</sup>

While the legal status of the case remains open, politically, the case remains effectively settled. Once the United States and the European Communities reached an agreement, none of the third parties or any other member states affected by the breach brought a case against the United States. Although other states could bring WTO litigation with the aim of receiving similar monetary compensation, no other members of the international trade community have sought to impose sanctions or seek compensation from the United States. In addition, the European Communities have effectively treated the matter as settled. The United States has not made any payments to the European Communities since 2004 and the European Communities have not renewed their compliant or requested the suspension of trade concessions due to the on-going trade breach.

Similarly, in the *United States—Subsidies on Upland Cotton* case, the Brazilian government brought a complaint alleging that the United States was subsidizing cotton production in breach of trade rules. Seventeen other members joined the case as third parties.<sup>146</sup> Both the panel and the Appellate Body found that the U.S. subsidies were illegal, and recommended that the United States withdraw these measures. After the United States failed to withdraw the contested subsidies, the Brazilian government requested the

139. *Id.* ¶ 3.1.

140. *Id.* ¶ 1.4.

141. Daniel Pruzin, *U.S. Will not Appeal WTO Panel Ruling Striking Down U.S. Music Licensing Law*, BNA WTO REPORTER, July 28, 2000.

142. Daniel Pruzin, *U.S. Finally Moves to Pay EU Musicians in Fund Settling WTO Licensing Spat*, BNA WTO REPORTER, May 14, 2003.

143. Article 25 Arbitration Report, *United States—Section 110(5) of the US Copyright Act*, WT/DS160/ARB25/1 (Nov. 9, 2001).

144. Notification of Mutually Acceptable Temporary Arrangement, *United States—Section 110(5) of the US Copyright Act*, WT/DS160/23 (June 23, 2003) See also Bernard O'Connor and Margareta Djordjevic, *Practical Aspects of Monetary Compensation: The US—Copyright Case*, 8 J. INT'L ECON. L. 127, 128 (2005) (discussing the case and its settlement).

145. O'Connor & Djordjevic, *supra* note 144, at 130.

146. The members were Argentina, Australia, Benin, Canada, Chad, China, Chinese Taipei, the EU, India, New Zealand, Pakistan, Paraguay, Venezuela, Bolivia, Japan, and Thailand.

suspension of concessions, and a WTO arbitration panel created a formula for determining the level of suspension, which permitted the suspension of USD 294.7 million in trade flows for 2009.<sup>147</sup> The United States and Brazil then reached a separate agreement in which the United States would maintain its subsidies, but provide Brazil with USD 147 million a year to refrain from exercising its right to suspend concessions.<sup>148</sup> As of this writing, the agreement resolving the dispute continues to govern the parties. Moreover, none of the other seventeen states that joined the dispute as third parties, including some other major cotton producers, has brought another case against the United States in spite of the fact that its trade-law-inconsistent policies remain in effect.<sup>149</sup>

Although it is impossible to rule out the possibility that the United States suffers informal costs from its continued breach, there is little evidence that the WTO system encourages the use of informal remedies. The WTO system explicitly restricts the ability of member states to supplement formal remedies with in-kind reciprocity. The dispute resolution system also seems to resolve the controversy, not only for the complaining state, but also for other states that may have similar claims. While it is very difficult to measure reputational gain and loss, we would expect some public statements objecting to the settlements that leave the breach in place; however, we do not observe this. If there are such objections, they have not been particularly loud. Indeed, public officials have embraced the WTO remedies as a price paradigm. Pascal Lamy (now the Director-General of the WTO), while acting as Trade Commissioner of the European Communities, described WTO dispute resolution as such: “[so] long as you pay the penalties, you can go on as you are.”<sup>150</sup> Rufus Yerxa, while acting as a U.S. trade official, stated that the WTO dispute settlement system was designed to mimic contractual remedies and not necessarily to demand compliance.<sup>151</sup> This indicates, but does not prove, that the audience understands the WTO to be the type of agreement in which the payment of remedies is consistent with cooperative behavior.

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147. See Panel Report, *United States—Subsidies on Upland Cotton*, WT/DS267/ARB/1 & WT/DS267/ARB/2 (Aug. 31, 2009).

148. Ed Taylor, *Brazil Suspends Sanctions Against U.S. Until 2012 in WTO Cotton Subsidy Dispute*, BNA WTO REPORTER, June 18, 2010.

149. See, e.g., Charan Devereaux et al., CASE STUDIES IN US TRADE NEGOTIATION, VOL. 2: RESOLVING DISPUTES 235–82 (2006) (introducing a case study of the U.S.-Brazil cotton dispute and discussing why West African states did not join as complaining parties).

150. Press and Communication Service Brussels, No. 3036, May 23, 2000, quoted in Petros C. Mavroidis, *Remedies in the WTO Legal System: Between a Rock and a Hard Place*, 11 EUR. J. INT’L L. 763, 808 (2000).

151. Rufus Yerxa, *The Power of the WTO Dispute Settlement System*, in KEY ISSUES IN THE WTO SETTLEMENT SYSTEM: THE FIRST TEN YEARS 3, 4 (Rufus Yerxa & Bruce Wilson eds., 2005).

### B. *Bilateral Investment Treaties*

Bilateral investment treaties are structured similarly to option contracts. The treaties are agreements that foreign investment will be welcomed in both states.<sup>152</sup> The treaties normally contain a number of provisions regarding investment, including descriptions of what capital measures are prohibited (rules against repatriation of capital and rules requiring local content in a production process) as well as a list of industries in which the state plans to maintain restrictions on foreign investment.<sup>153</sup> Yet the core obligation of most bilateral investment treaties is the promise to pay prompt, adequate, and full compensation if the host government expropriates investment.<sup>154</sup> This core obligation is structured as an option contract in the sense that the government does not promise to refrain from expropriating the investment for a public purpose, but rather promises to provide compensation if it does.<sup>155</sup> Consequently, the decision of a state to expropriate property for a public purpose is not itself a breach of the substantive terms of the treaty. For instance, the United States can continue to take property for a public purpose under the bilateral investment treaty without breaching any of the investment treaties it has signed. The breach occurs only if the state fails to pay prompt, adequate, and effective compensation.<sup>156</sup>

To be clear, the state may be breaching its promise to the investor.<sup>157</sup> A firm and the government may enter into a detailed agreement regarding the terms of a firm's proposed investment. For instance, a firm offering to make a large investment may receive a favorable tax rate or the government may

152. Often investment provisions are incorporated as part of a bilateral or regional trade agreement. The investment provisions in these agreements generally mimic the terms of the bilateral investment treaties. See Kenneth Vandeveld, *A Brief History of International Investment Agreements*, 12 U. C. DAVIS J. INT'L L. & POL. 157, 179–80 (2005–06).

153. See generally ANDREAS LOWENFELD, *INTERNATIONAL ECONOMIC LAW* (2010).

154. Many capital exporting states argue that this is the minimum standard of treatment for foreign investment that customary international law requires. What customary law requires is controversial. Over the last century, many developing states have contested the claim that customary international law requires compensation. See generally LOWENFELD, *supra* note 153. More recently, the question of whether the network of bilateral investment treaties has created new customary international law is also contested. Commentators argue that there are now thousands of bilateral investment treaties and that this should qualify both as state practice and as evidence of *opinio juris*. See, e.g., Jeswald W. Salacuse, *The Emerging Global Regime for Investment*, 51 HARV. INT'L L.J. 427, 428–29 (2010). Yet there is a difference between what concessions states are willing to bargain for and what they have a legal obligation to provide as a matter of law. In addition, what qualifies as state practice depends on one's view of the absolute number of BITS in existence or the practice of the international system as a whole. The number of bilateral investment treaties in existence—hundreds—is a small proportion of the number of possible bilateral treaties that could exist in the international system. The failure of multilateral investment treaty negotiations further casts doubt on the idea that bilateral treaties reflect a consistent state practice.

155. 2004 Model Bilateral Investment Treaty, available at <http://www.state.gov/documents/organization/117601.pdf>. The right of the government to control the territory within one's state is considered not only a key sovereign right but also a necessary characteristic of statehood.

156. See generally LOWENFELD, *supra* note 153.

157. See generally Jason Webb Yackee, *Pacta Sunt Servanda and State Promises to Foreign Investors Before Bilateral Investment Treaties: Myth and Reality*, 32 FORDHAM INT'L L.J. 1550 (2009) [hereinafter Webb Yackee, *State Promises*].

promise to build the local infrastructure necessary for the investment's success.<sup>158</sup> Where the government fails to maintain its agreement, arbitration panels (relying on either bilateral investment agreements or customary international law) have found that the state has breached its agreement with the firm.<sup>159</sup> Yet the host state's decision to breach a promise to the investor does not necessarily breach the host state's promise in the investment treaty to the investor's home state. The bilateral investment treaty only demands that the host state take the property for a public purpose and compensate the investor. So long as the host state pays fair compensation in a prompt manner, then the terms of the agreement are met.

Bilateral investment treaties have garnered significant scholarly attention and popular criticism within the last decade for a variety of reasons. First, it is unclear whether these agreements provide mutual benefits to the parties or, in contrast, whether they are fundamentally harmful to developing states.<sup>160</sup> Many scholars question whether bilateral investment treaties actually increase foreign direct investment to developing countries.<sup>161</sup> Along similar lines, arbitration panels have tended to interpret the agreements with an investor-friendly slant, frequently finding that any change in the regulatory or tax treatment of a foreign investment is a form of expropriation.<sup>162</sup> Such regulatory takings are different from the "classic" expropriation cases, in which the government seizes control of a foreign natural resource extraction project (for example, oil or copper) and takes the revenues from the project as its own without compensation.<sup>163</sup> In a regulatory taking—or "creeping" expropriation—case, the government is not directly profiting from the expropriation in the sense that it is not taking the revenues from a project that the foreign investor would otherwise enjoy.<sup>164</sup> The government may benefit from greater political support due to higher regulatory standards popular among key constituencies, but the government in these cases does not have the intent to seize the foreign property and gain the revenue from the investment for itself.<sup>165</sup> The idea that regulatory ac-

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158. See generally Debra Spar, *Attracting High Technology Investment: Intel's Costa Rica Plant*, Foreign Investment Advisory Service Occasional Paper 11 (1998).

159. See Webb Yackee, *State Promises*, *supra* note 157.

160. See generally Andrew Guzman, *Why do LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639 (1998) [hereinafter Guzman, *LDCs*].

161. See, e.g., Jason Webb Yackee, *Are BITs Such a Bright Idea? Exploring the Ideational Basis of Investment Treaty Enthusiasm*, 12 U.C. DAVIS J. INT'L L. & POLICY 1550 (2005); Guzman, *LDCs*, *supra* note 160; Salacuse, *supra* note 154 (noting that BITs are built on the assumption that the developing country will benefit from increased foreign direct investment but acknowledging that this assumption has not been empirically demonstrated in a robust fashion).

162. See generally Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, 78 N.Y.U. L. REV. 30 (2003).

163. See generally RAYMON VERNON, *SOVEREIGNTY AT BAY* (1971).

164. *Id.*

165. See generally Been & Beauvais, *supra* note 162; *Metalclad Corp. v. United Mexican States*, ICSID Case No. ARB(AF)/97/1 (Aug. 30, 2000) (bad government motive not needed to find expropriation).

tions can be takings for the purposes of an investment treaty is controversial with the governments of developed states because it exposes them to investor liability for common regulatory actions, such as environmental regulations or local zoning ordinances.<sup>166</sup>

Second, bilateral investment treaties are unique among international economic agreements in that private investors have standing to sue the host country government.<sup>167</sup> In almost all other international economic agreements, governments serve as gatekeepers for international litigation.<sup>168</sup> The expansion of standing to individual investors allows private actors to file claims, even when their home governments would not do so for diplomatic or other reasons. Moreover, the judgments of the arbitration panel are generally enforceable anywhere the host government has assets. This combination of the freedom to bring suits without the home state's authorization and the authority to enforce judgments against the host state provides foreign investors with much greater autonomy from home government action than in other economic agreements.<sup>169</sup>

This Article focuses on the obligations and remedies in these treaties. Whether one wants to view a bilateral investment treaty as an option contract or as an obligation not to breach, the remedy remains the same: compensation based on the harm to the investor.<sup>170</sup> The structure of the remedy—one of compensation, without any assessment or incorporation of fault—indicates that the bilateral investment treaty system is a pricing scheme. Governments buy the right to expropriate property so long as they pay for the harm incurred by the foreign investor.<sup>171</sup> Arbitration panels do not have the authority to issue punitive damages or an alternative amount that would deter expropriation.

While the structure of the remedy is informative, it is still important to gauge the community reaction to the extent possible. Does the payment of the remedy act as a fulfillment of the host country's obligations or does the act of expropriation lead to a reputational loss as a cooperative state? In this case, it is helpful to distinguish between two audiences: other states—the bilateral investment treaty partners or other states observing the investment—and private investors. These two audiences may have different perspectives on whether compensation buys compliance because they come from structurally different positions. Governments are sometimes foreign in-

166. Been & Beauvais, *supra* note 162, at 116–28.

167. See Alan O. Sykes, *Public Versus Private Enforcement of International Economic Law: Of Standing and Remedy*, 34 J. LEGAL STUD. 631, 633–34 (2005) [hereinafter Sykes, *Public Versus Private Enforcement*].

168. See *id.* at 635–36.

169. See *id.* at 643–44.

170. While the international arbitration panels that hear the cases and award damages are authorized to award lost profits, the calculation of the harm rarely includes lost profits because the numbers are considered too speculative. See, e.g., *Metalclad Corp. v. United Mexican States*, ICSID Case No. ARB(AF)/97/1, ¶¶ 121–22 (Aug. 30, 2000). In most cases, the award is based on the amount of the actual investment rather than the expected gain from the project.

171. Domestic investors only have recourse to local law.

vestors (that is, through sovereign wealth funds), but they are always in a position of possibly needing to control the property within their state. Investors may sometimes benefit from expropriations by the state (either indirectly through infrastructure projects or directly by use of government power to acquire property for their project), but they always bear some risk of expropriation from the government. As such, governments may be more receptive to compensation purchasing the right to expropriate than investors are.

The home governments of investors have been notably quiet on issues of investment disputes. So long as the host government complies with the terms of the treaty and arbitrates disputes with complaining investors, home states seem satisfied with the actions of the host state. While silence itself is hard to interpret, the structure of the bilateral investment treaty system provides some context for viewing silence as approval. Before the entry of bilateral investment treaties and standing for private investors, home governments frequently were dragged into disputes between their nationals and host states. These disputes frequently led to extended diplomatic tensions between the home state and the host state and occasionally to the threat of force (that is, gun-boat diplomacy).<sup>172</sup> Bilateral investment treaties provided both home states and host states a means out of extended diplomatic disputes. Part of the political function of bilateral investment treaties is to “depoliticize” investment disputes.<sup>173</sup> Home states can extricate themselves from investment disputes and carry on friendly diplomatic relations with foreign states without getting mired in the economic claims of their nationals. As Jeswald Salacuse argues, a bilateral investment treaty “allows [home governments] to say to their nationals and companies aggrieved by host government acts that ‘you have your own remedy in the treaty. Use it if you wish. Go away and don’t bother us.’”<sup>174</sup> Host states are under an obligation to compensate foreign investors, but arbitration panels determine the extent of compensation due, rather than the investors’ home state.

Because home states and host states created bilateral investment treaties in part to keep investment disputes from being inter-state disputes, silence by home governments can be reasonably interpreted as a sign of satisfaction with the regime. Host governments remain treaty partners in good stead so long as they comply with the treaty’s arbitration provisions and remedy regime. To the extent that governments have been vocal about an investment regime, it has been to advocate for less liability for host countries, not more. After an arbitration involving the North American Free Trade Agreement’s (“NAFTA”) investment chapter, the United States, Canadian, and Mexican

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172. See Michael Tomz, Reputation and the Effect of International Law on Preferences and Beliefs 28 (Feb. 2008) (unpublished manuscript), available at <http://www.stanford.edu/~tomz/working/Tomz-Intl-Law-2008-02-11a.pdf> [hereinafter Tomz, Preferences and Beliefs].

173. Salacuse, *supra* note 154, at 463.

174. *Id.*

governments issued a joint memorandum stating that the investment chapter should be narrowly interpreted by arbitration panels.<sup>175</sup> The memorandum was a result of the arbitration panel's decision that part of the host's state obligation to foreign investors included making all of its regulations (national, state, and local) transparent to the investor.<sup>176</sup> The governments' memorandum expressed their disagreement with the arbitration panel and their joint view that transparency was not part of the minimum standard of treatment for foreign investment that the investment chapter required.<sup>177</sup>

By contrast, the audience of private investors is less likely to have an option-contract view of bilateral investment treaties. If investors are equally happy with compliance with the investment agreement and compliance with the remedy regime, then there should be no decrease in foreign investment in a particular host state after a public investment dispute. Recent empirical studies demonstrate that host states do experience a decrease in foreign investment after a complaining investor has brought an arbitration claim against the host country.<sup>178</sup> This indicates that investors are not neutral regarding compliance or the payment of compensation. Yet for the purposes of determining the reputational impact on the host state of complying with the treaty's remedy regime but not its substantive obligations, it is important to distinguish between investors' views of whether the state is a good treaty partner and whether the state has a higher political risk than previously believed. Investors' greater reticence to invest in host states that have recently been involved in investment litigation could be the result of investors' isolation of the state as part of an informal sanction for law-breaking or it could reflect the investors' updated view of the level of risk involved in foreign investment in that state or both.<sup>179</sup> The current evidence cannot distinguish between these possibilities.

Thus in this case, it is possible that different audiences view the relationship between the treaty's substantive obligations and the remedy regime in different ways. To the extent that the host state is appealing to an investor audience, compliance with the investment treaty's remedy regime may not be sufficient to prevent a loss of reputation. Yet, to the extent that the host state is primarily interested in keeping a good reputation for cooperativeness with other governments, compliance with the remedy regime may be sufficient.

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175. See NAFTA Free Trade Commission, *Notes of Interpretation on Chapter 11 Provisions* (July 31, 2001), available at <http://www.international.gc.ca/trade-agreements-accords-commerciaux/disp-diff/nafta-interpr.aspx?view=d>.

176. *Id.*; see also Salacuse, *supra* note 162, at 455–56.

177. Salacuse, *supra* note 154, at 455–56.

178. Todd Allee & Clint Peinhardt, *Contingent Credibility: The Reputational Effects of Investment Treaty Disputes on Foreign Direct Investment*, 65 INT'L ORG. 401, 401 (2011).

179. If the political risk of investing in a state rises, then all else being equal, we should expect the level of investment to decrease as the expected gains of the investment are lower.

## IV. THE DESIGN OF REMEDY REGIMES

Even if the drafters of a treaty do not actively consider the relationship between the remedy regime and the audience's perception of the mandatory nature of the substantive rules, such a relationship can exist. Remedies influence the audience's beliefs, and it is these beliefs that determine whether a remedy is a price or a sanction. Low remedy regimes can thus lead to two different situations in international negotiations. The first is an intentional match between lower remedies and less mandatory first-order rules. This is the situation in which the treaty members prefer compliance with the agreement's substantive rules but also wish to permit breach under certain circumstances. In such cases, the remedy regime can facilitate the breach in a manner the negotiating parties intended by displacing reputational costs.

The second is a mismatch between the intention of the treaty drafters and the beliefs of the audience. The negotiating parties may desire that the substantive terms of the treaty be fully binding but: (1) they have access to few remedies; or (2) they begin with low remedies with the aspiration of increasing the severity of the remedies in the future. In such a case, the remedies may influence the beliefs of the audience in a counter-productive manner. There is a risk that the remedy will create a set of beliefs concerning acceptable state behavior that is contrary to the intention of the negotiators. The remedy will not be the only factor that influences the audience's beliefs, but it can be an important factor.

In this section, I focus on the possibility that negotiators *purposefully* select a remedy regime that emphasizes compliance with second-order rules. I address the possibility of a mismatch between remedy regimes and the negotiators' intentions in Part V.

A. *Costly Signals: Complying (or Not) with Remedies*

The existence of dispute resolution systems and explicit remedy rules can redefine cooperativeness, from compliance with the treaty's substantive rules to compliance with the secondary rules of the treaty. The "cooperativeness" in this latter type of compliance—that is, compliance with second-order rules—is somewhat unique to international law. In domestic law, compliance with second-order rules may not be seen as particularly cooperative. Paying a judgment or otherwise abiding by a court order is not voluntary in domestic law. While the state may not enforce compliance with the contract, state power is available to enforce compliance with any court-ordered remedies.

The same is not true in international law. The international system famously lacks a centralized enforcement system, and thus compliance with second-order rules (much like compliance with first-order rules) is voluntary. The state could choose to break both first-order and second-order treaty

rules. This is not to discount the possibility that peer pressure, acculturation, or reciprocity (or even coercion where there is a large power disparity between states) could and do sustain compliance with international law. These effects can be substantial, but the lack of a centralized government with a monopoly on the use of force is a core feature of international relations that affects the dynamics of the international system. The default is a lack of enforcement, rather than state-backed enforcement.<sup>180</sup> Particularly when dealing with more powerful states, the adherence to judgments or other international remedies is essentially voluntary. As a consequence, the decision of a state to comply with an international order is at least partially cooperative. It is an action that keeps the state within the framework of the international agreement. Compliance with second-order rules does not necessarily eliminate any stain from the breach of the first-order rule, but it does lessen the reputational loss (relative to a system without such an institution) because it provides an opportunity for the state to remain in compliance with the broader treaty regime.

The enforcement institution itself can determine what qualifies as compliance with a regime. In their highly influential discussion of the medieval law merchant, Paul Milgrom, Douglass North, and Barry Weingast provide a model where reputational institutions (the law merchant) are sufficient to sustain international trade when no local or national-level government enforcement of contracts is possible.<sup>181</sup> Their model addresses the problem of a medieval merchant. The merchant could sue another merchant who had allegedly cheated him wherever the transaction took place, but the ensuing judgment was often hard to enforce because the respondent merchant could be many jurisdictions away. Milgrom, North, and Weingast model an informational solution: the institution of the law merchant (or other reputational network) that could maintain a cooperative equilibrium even where state enforcement of contract was lacking.<sup>182</sup> As the authors describe it, the law

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180. States could make an *ex ante* payment into a fund, yet this is also voluntary, just at an earlier point—before the hearing, rather than after—and only up to the amount contributed to the fund. In the U.S.-Iranian Claims cases, the United States had seized Iranian assets and thus “volunteered” Iranian contributions to the fund. This is not the normal case, nor would most international lawyers want the United States’ unilateral decision to seize foreign assets to be the primary means of providing remedies for breach of contract.

181. Milgrom, North & Weingast, *supra* note 1, at 4.

182. The narrative that Milgrom, North, and Weingast relate is historically dubious, but remains highly influential with political scientists and international law scholars. Historians question whether reputational networks, rather than state actors, were primarily responsible for enforcing merchant contracts. See Emily Kadens, *Order Within Law, Variety Within Custom: The Character of the Medieval Merchant Law*, 5 CHI. J. INT’L L. 39, 51–52 (2004); Stephen E. Sachs, *From St. Ives to Cyberspace: The Modern Distortion of the Medieval ‘Law Merchant’*, 21 AM. U. INT’L L. REV. 685, 698–712 (2006) (arguing that local authorities enforced contracts). Stephen Sachs additionally argues that Milgrom, North, and Weingast fundamentally misperceive the medieval institution in the sense that there was never an *individual* who was a law merchant. Sachs maintains that there was, at best, a general threat of exclusion from the merchant guilds. Sachs, *supra*, at 695, 699 n.34, 706–12. The term “law merchant” also has a second meaning, which is separate from contract enforcement. Law merchant or *lex mercatoria* can also mean a uniform set of commercial law established by merchants and enforced by merchants participating in

merchant would keep a record of all merchants who had failed to pay outstanding judgments against them. Merchants who were considering a new contracting partner could pay a fee to the law merchant to discover whether the prospective partner had any outstanding judgments, and thereby avoid “cheating” merchants. In Milgrom, North, and Weingast’s model, the institution of the law merchant disseminates information regarding the nature of the prospective contracting parties, but only information on second-order violations.<sup>183</sup>

The enforcement institution shaped the audience’s beliefs about what cooperative behavior entailed. By selecting “outstanding judgment” as the relevant criterion for judging cooperativeness, the institution of the law merchant implicitly determined that all merchants who abide by second-order rules are good contracting partners. The process of defining cooperative behavior emphasized one form of compliance, namely compensation of the breached-upon party, and de-emphasized other forms of compliance, such as adherence to the terms of the contract.<sup>184</sup> Here, the system of dispute resolution effectively launders substantive law breaches for reputational purposes and puts all of the emphasis on paying the judgment. Only merchants who breached the contract (cheating) *and* violated second-order rules (not compensating) were labeled as “uncooperative.” Dispute resolution can, thus, “normalize” violations of the regime’s substantive rules by providing a

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international trade. See Charles Donahue Jr., *Medieval and Early Modern Lex mercatoria: An Attempt at the Probatio Diabolica*, 5 CHI. J. INT’L L. 21 (2004) (discussing this definition and contesting its historical reality). The law merchant idea also remains popular in commercial law scholarship for the idea that businesses may be able to govern themselves separate from state actors. See Robert Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1646–50 (1996) (acknowledging the historically questionable foundations of the medieval law merchant but highlighting the importance of the analysis to current economic activity). Modern historians generally do not believe that a uniform system of merchant law existed in the medieval period. Donahue, *supra*, at 21–26 (challenging whether there was a specific merchant law in the medieval period rather than local law with certain procedural accommodations to merchants); Kadens, *supra*, at 42–47 (arguing that enforcement was primarily a state function and that there was no uniform independent merchant law at trading fairs); Sachs, *supra*, at 687–794 (arguing that merchants may have had special status at trading fairs but that merchants’ contracts were governed by local law).

183. In medieval trade, there was a substantive rule to abide by the terms of a contract. Any breach of the terms of the contract was in contravention of contract law—“cheating” in Milgrom, North, and Weingast’s terms. Notably, the law merchant did not produce a list of all the merchants who had judgments registered against them for breach of contract, that is, all cheating types. Rather, the law merchant only reported on merchants who had *failed to pay* an outstanding judgment. If the merchant abided by second-order rules, making the required payment of the judgment, then the merchant was labeled as “cooperative,” even if the merchant had cheated on the contract.

184. While Milgrom, North, and Weingast highlight how information dissemination deters cheating, their example does not necessarily support this conclusion. Rather, their narrative supports a conclusion that second-order violations (the failure to pay a judgment for cheating) could be deterred. This is a different type of cooperation, one premised on an obligation to compensate rather than an obligation to abide by the terms of the contract. This difference matters to analyses of reputation and legal institutions. Milgrom, North, and Weingast argue that the merchant’s reputation for honesty is what supported the international trade system. Yet the narrative they tell leads to a slightly different conclusion with regard to reputation. The important metric for reputation is not the compliance with a contract’s substantive rules, or cheating, but compliance with the legal regime’s judgments.

framework whereby states can deviate from the treaty's substantive provisions but then adhere to the treaty's remedy regime. So long as the state does not violate the regime's framework rules and consistently submits to the jurisdiction of the dispute resolution institution and accepts its judgments, the breaching state can demonstrate that it continues to be cooperative.

This does not mean that the state may not suffer any reputational loss for the breach even if it complies with the remedy regime. Rather, the claim is relative: the reputational loss the state will suffer is less than it would be without a dispute resolution system. The assignment of a remedy permits the state to demonstrate its adherence to the treaty's framework. Just as a dispute settlement can prevent injured states from over-retaliating and injuring the cooperative equilibrium of the agreement,<sup>185</sup> dispute settlement systems can allow breaching states to demonstrate their continued cooperativeness with the treaty's second-order rules. Dispute resolution can thus be a mechanism of escape as well as enforcement, managing departures from the regime's substantive obligations yet keeping states within the cooperative framework of the agreement.

The WTO system allows states to demonstrate that they are still cooperative with the overall treaty regime by complying with the dispute settlement system. This includes submitting to the jurisdiction of the treaty regime and accepting the remedies that it assigns. The decision to remain within the regime and accept an international court's jurisdiction should not be taken for granted. Domestic legislators can make political hay out of rejecting the authority of an international body to evaluate the consistency of national policies with treaty obligations. The decision to abide by the dispute resolution system is even more costly if it requires the state to accept a loss of trade concessions. The willingness of governments to do so allows them to show through costly actions that they remain committed to the treaty's goals and cooperation with other member states.

While many states have breached the WTO's substantive provisions, WTO member states' remarkable compliance with the WTO's dispute resolution system might be the trade regime's most significant, if underappreciated, achievement.<sup>186</sup> Even when states expect that they will lose a case, WTO members have accepted the system's jurisdiction.<sup>187</sup> When complaining states have lost cases, they have not imposed sanctions on the alleged breaching state despite the ruling. Similarly, when complaining states receive WTO authorization to retaliate, breaching states have not threatened

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185. Abbott & Snidal, *supra* note 2, at 431; Thompson, *supra* note 38, at 309.

186. See generally Davey, *supra* note 131 (noting high compliance as part of the WTO's implementation success).

187. Cf. Davey, *supra* note 131 (discussing the outcome of disputes, most of which found violations). Given the scope of Davey's inquiry, if a state refused to respect the jurisdiction of the court, this would likely be included in his discussion.

counter-retaliation. This compliance with second-order rules has been very high, even for politically sensitive issues, such as subsidies for agriculture and civil aircraft.<sup>188</sup> Like Milgrom, North, and Weingast's narrative of the law merchant, this continued acceptance of the jurisdiction and judgments of the WTO dispute resolution system may become the touchstone for judging state cooperativeness.

The general approach of developed states to bilateral investment treaties has been to consider treaty partners to be in good standing so long as the damages for any expropriation are paid. Serious pressure is brought to bear only when a treaty partner *violates* the treaty, either by refusing to go to arbitration or by refusing to pay the arbitral award. For instance, the United States has taken action against Argentina (including voting against additional loans to Argentina in multilateral lending agencies and denial of trade benefits) when Argentina refused to pay arbitral awards in favor of American investor claims.<sup>189</sup>

This view of remedies—as providing opportunities for the international regime to permit deviations as well as for states to demonstrate their continued participation in the regime—is radically different from other views of remedies that focus on the exclusion of states from cooperative regimes for acts of noncompliance. For instance, Oona Hathaway and Scott Shapiro have recently argued that international remedies are a form of “outcasting.”<sup>190</sup> The primary focus of Hathaway and Shapiro's article is whether international law can legitimately be considered “law,” as it is not enforced through a centralized institution with the threat of overwhelming coercive force.<sup>191</sup> They argue that international law is law because it is enforced by the threat of ostracism.<sup>192</sup> Drawing on analogies to the legal system in medieval Iceland, with its system of exile, and to canon law, with its system of excommunication, Hathaway and Shapiro maintain that international law remedies effectively cast states out of the benefits of cooperation and thereby establish a non-violent but effective system of enforcement.<sup>193</sup>

In a purely instrumental sense, Hathaway and Shapiro are certainly correct that denying states benefits can provide them with an incentive to alter their policies. Yet in a social sense, their focus on outcasting and excommunication leans heavily on the idea of community opprobrium. As the authors note, this concept is intimately related to concepts of “shaming” and public

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188. See generally *id.*

189. Doug Palmer, *Obama Says to Suspend Trade Benefits for Argentina*, REUTERS, Mar. 26, 2012, available at <http://www.reuters.com/article/2012/03/26/us-usa-argentina-trade-idUSBRE82P0QX20120326>.

190. See generally Oona A. Hathaway & Scott J. Shapiro, *Outcasting: Enforcement in Domestic and International Law*, 121 YALE L.J. 252 (2011).

191. *Id.* at 255–57.

192. *Id.* at 258.

193. *Id.* at 282–308 (arguing that outcasting is the dominant form of enforcement in international law).

denunciation.<sup>194</sup> Their discussion of remedies is reflective of a broader theme in international law that views remedies as a means of punishing defections and enforcing rules.<sup>195</sup> Yet remedies do not have to have a social meaning that connotes shame or punishment. Rather than being cast out of an international regime, explicit remedy rules provide a means for states to deviate from substantive rules but remain within the treaty's collaborative framework. Remedies can exact a cost from states that adopt certain policies, but this cost can be viewed as a mutually accepted expense for staying within the community. Moreover, compliance with the remedy is itself an act of cooperation with the treaty regime. Instead of being excluded from future collaboration, remedies can provide an occasion for the state to express its on-going interest in supporting the regime. This dual nature of remedies—the cost but also the reintegration—is neglected within the outcasting and shaming view. By downplaying the restorative aspect of remedies, this conventional view overlooks how remedies can make deviations easier for the state to bear, promoting looser but more robust forms of cooperation.

#### B. *Designing Dispute Resolution to Displace Reputational Sanctions*

This analysis highlights how governments may create formal dispute resolution systems to lower the costs of deviation rather than to raise them. Remedy regimes can provide states, purposefully or not, with an alternative to compliance at a certain price. International law scholars generally accept that formal dispute resolution systems will increase the level of compliance with international rules. Kenneth Abbott and Duncan Snidal argue that a system of independent international tribunals can increase states' compliance with international law, relying in part on governments' concern for their reputations to support their argument.<sup>196</sup> In a related vein, Andrew Guzman argues that states will often refuse to create third-party dispute settlement mechanisms because these mechanisms impose reputational costs on the losing state without creating significant benefits for the successful state.<sup>197</sup> These scholars are not necessarily mistaken, but in some cases a different causal relationship may exist. By embedding conflict resolution within a broader cooperative arrangement, formal dispute resolution institutions may legitimize deviations from a treaty's substantive rules and lower the reputational costs of breach. Thus, negotiators may create a system of third-party tribunals to hear disputes as a means of facilitating breach, thereby adding flexibility to a regime. This account also fits with political scientists' view of

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194. *Id.* at 308–10.

195. See, e.g., George W. Downs, David M. Rocke & Peter N. Barsoom, *Is the Good News About Compliance Good News About Cooperation?*, 50 INT'L ORG. 379 (1996).

196. See generally Abbott & Snidal, *supra* note 2; see also Helfer & Slaughter, *Supranational Adjudication*, *supra* note 8, at 276; Helfer & Slaughter, *International Tribunals*, *supra* note 2.

197. See generally Guzman, *The Cost of Credibility*, *supra* note 4.

dispute resolution as a means of decreasing the rigidity of legal obligations and managing conflict within a cooperative framework.<sup>198</sup>

### 1. *Flexibility and Cooperation*

Discussions of institutional design in the political science literature emphasize the role of flexibility mechanisms in structuring international cooperation.<sup>199</sup> Flexibility in the structure of the substance or the process of the institutions permits treaty designers to modulate the terms of the international agreement in a manner that can maximize the joint gains of cooperation to all of the parties.<sup>200</sup> The need for flexibility comes from a number of sources including heterogeneity in the preferences of parties and from uncertainty regarding the domestic effects of the legal agreements, the actions of partner states, or the likelihood of future economic or political shocks. By modulating the obligations of the international agreement, more parties may join the agreement and may be able to comply with the terms of the agreement under a greater variety of economic and political conditions.<sup>201</sup>

An example of an inflexible (or perfectly rigid) agreement is an agreement that has substantive obligations that do not permit derogation under any future state of the world. The agreement would not permit any reservations and would not have an exit clause. In addition, the negotiating states would not include any procedural voting rules or other governance mechanisms whereby substantive obligations could be modulated or withdrawn in the future. States could presumably join the agreement at a later point in time, but once committed, the state could not diminish its obligations. In reality, no international agreement would actually meet these conditions. All agreements are renegotiable if all of the parties wish to release one another from their obligations or revise the agreement; however, agreements can be designed to make renegotiation easier or harder. This is true either at the level of the existence of the entire agreement or of specific obligations within the agreement's framework.<sup>202</sup>

198. See, e.g., B. Peter Rosendorff, *Stability and Rigidity: Politics and Design of the WTO's Dispute Resolution Procedure*, 99 AM. POL. SCI. REV. 389 (2005) [hereinafter Rosendorff, *Stability and Rigidity*]; Leslie Johns, *Depth Versus Rigidity in the Design of International Trade Agreements* (Sept. 3, 2012) (unpublished manuscript), available at [http://www.sscnet.ucla.edu/polisci/faculty/ljohns/DvR\\_120903.pdf](http://www.sscnet.ucla.edu/polisci/faculty/ljohns/DvR_120903.pdf).

199. See, e.g., Barbara Koremenos, Charles Lipson & Duncan Snidal, *The Rational Design of International Institutions*, 55 INT'L ORG. 761 (2001). While international law scholars are less likely to use the term "flexibility," they are familiar with the legal mechanisms by which flexibility is achieved.

200. See generally Barbara Koremenos, *Loosening the Ties that Bind: A Learning Model of Agreement Flexibility*, 55 INT'L ORG. 289 (2001).

201. See Sykes, *Protectionism as a "Safeguard," supra* note 12; Rosendorff & Milner, *supra* note 12; Rosendorff, *Stability and Rigidity, supra* note 198; Johns, *supra* note 198.

202. See Koremenos, Lipson & Snidal, *supra* note 199, at 773. Koremenos, Lipson, and Snidal distinguish between two types of flexibility: adaptive and transformative. Adaptive flexibility mechanisms allow states to make deviations from specific commitments, such as escaping from some tariff bindings for a period of economic hardship. Transformative flexibility mechanisms are governance rules that allow the parties to alter the substantive rules that bind the member states, such as voting rules to modify treaty obligations.

Rather than having a rigid agreement, parties may wish to introduce design mechanisms that provide greater options for states to modulate their legal obligations, either presently or in the future.<sup>203</sup> Exit clauses permit a state to renounce an agreement and end the state's legal obligations under the treaty.<sup>204</sup> Escape clauses permit members of the agreement to deviate from an agreement's substantive provisions under certain conditions, such as exceptional economic duress or political upheaval.<sup>205</sup> Agreements can also include governance measures that permit the parties to amend their rules after the treaty negotiations have concluded or to delegate rule-making to internal committees or other international institutions.<sup>206</sup>

Like other forms of institutional design, dispute resolution systems can also be a flexibility mechanism. Similar to escape clauses that specify *ex ante* when states can deviate from their obligations, dispute resolution procedures can specify *ex ante* what disputes the system will have jurisdiction to adjudicate and what the remedies for breach will be. In both systems, the treaty negotiators may prefer adherence to the rules detailed in the treaty but establish a set of conditions under which the parties may deviate from these obligations. With escape clauses, the treaty negotiators specify political or economic conditions under which the parties may deviate from the treaty's rules. With dispute resolution systems, the treaty negotiators can explicitly provide for certain remedies in the case of breach. Political scientists have explicitly modeled dispute resolution systems as a means of anticipating and managing future defections from the agreement. Peter Rosendorff discusses how the WTO's dispute resolution system works as a flexibility mechanism

203. See generally Laurence Helfer, *Flexibility in International Agreements*, in INTERNATIONAL LAW AND INTERNATIONAL RELATIONS THEORY: TAKING STOCK (Jeffrey L. Dunoff & Mark A. Pollack eds., 2012).

204. See generally Laurence Helfer, *Exiting Treaties*, *supra* note 83. States may still have international legal obligations under customary international law if the treaty was meant to codify international customary law or has subsequently been accepted as customary international law. See *id.* For a discussion of whether states should be allowed to exit unilaterally from customary law, see generally Curtis A. Bradley & G. Mitu Gulati, *Withdrawing from International Custom*, 120 YALE L.J. 202 (2010).

205. For instance, trade agreements often include safeguard measures, which allow states to raise tariffs on imports to protect vulnerable domestic industries if there has been a dramatic increase in imports, and this rise threatens to cause material injury to a domestic industry. See generally Sykes, *Protectionism as a "Safeguard"*, *supra* note 12; Bagwell & Staiger, *supra* note 12; Rosendorff & Milner, *supra* note 12. For a discussion of how escape clauses are used and adjudicated in practice, see Pelc, *supra* note 128. Some human rights agreements permit their members to derogate from some rights in times of national emergency. See Joan F. Hartman, *Derogation from Human Rights Treaties in Public Emergencies: A Critique of Implementation by the European Commission and Court of Human Rights and the Human Rights Committee in the United Nations*, 22 HARV. INT'L L.J. 1, 8 (1981); Robert E. Norris & Paula Desio Reiton, *The Suspension of Guarantees: A Comparative Analysis of the American Convention on Human Rights and the Constitutions of the States Parties*, 30 AM. U. L. REV. 189 (1980).

206. See Koremenos, Lipson & Snidal, *supra* note 199, at 773. For a discussion of how international agreements can delegate rulemaking, see Curtis A. Bradley & Judith Kelley, *The Concept of International Delegation*, 71 LAW & CONTEMP. PROBS. 1 (2008); Tom Ginsberg, *Locking in Democracy: Constitutions, Commitment, and International Law*, 38 N.Y.U. J. INT'L L. & POL. 707, 734 (2006); Tom Ginsberg, *International Delegation and State Disaggregation*, 20 CONST. POL. ECON. 323 (2009). Even sovereign debt contracts can include terms that allow the state's creditors to jointly amend the terms of the debt contract. See Stephen J. Choi, G. Mitu Gulati & Eric A. Posner, *Political Risk and Sovereign Debt Contracts* (John M. Olin Law & Economics Working Paper No. 583 (2d Series), 2011).

that reduces the fragility of the cooperative equilibrium in the trade agreement.<sup>207</sup> As he argues, the dispute resolution system “enhances the stability of the cooperative regime; it does so not because it has become more rigid, but because it has become *more flexible*.”<sup>208</sup> Similarly, Leslie Johns models dispute resolution systems in global and regional trade agreements as mechanisms that permit greater deviations from trade rules while supporting cooperative trade policies.<sup>209</sup>

Interestingly, neither the political science literature nor the international law literature has integrated the recent work on flexibility with the broader literature on cooperation and its emphasis on the role of informal enforcement mechanisms, such as reputation. This is notable because discussions of flexibility have important implications on how governments and other non-state actors understand states’ actions within a regime. Historically, political scientists have placed great weight on the ability of reputation to maintain cooperative agreements in an international system that lacks a centralized enforcement system.<sup>210</sup> Yet the flexibility approach to institutions creates confusion and noise in defining cooperative behavior and can potentially undermine the informal system supporting cooperation.

Flexibility mechanisms pose a challenge to conventional international relations theory because the reputational analysis is based on the idea of compliance with a set of legal obligations within a treaty agreement. To the extent that legal obligations are clear and escape options are limited, a reputation for cooperativeness is relatively easy to determine.<sup>211</sup> Either the state complies with its treaty obligations, in which case it has a good reputation as a cooperative treaty partner, or it does not, and its reputation suffers. Where the agreement itself provides a greater range of options, the possible interpretations of the state’s actions as cooperative or noncooperative become more nuanced. Flexibility mechanisms create a grey area, where actions may be formally legal but are not necessarily supportive of the goals of the regime. As a result, the reputational impact of using flexibility provisions is far from clear and the flexibility literature does not discuss the possible reputational impact of these provisions.

Consider, for instance, a state’s decision to exit a treaty regime. So long as the state has complied with all of the treaty’s requirements for exiting the agreement, the state’s action is not a breach of the agreement.<sup>212</sup> The state has acted consistently with the bargained-for terms of the agreement. Nonetheless, other treaty members may not view the state’s exit as particularly cooperative. By leaving the regime, the state is withdrawing from an activ-

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207. Rosendorff, *Stability and Rigidity*, *supra* note 198, at 392–96.

208. *Id.* at 389.

209. Johns, *supra* note 198.

210. See sources cited *supra* note 1.

211. See generally GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1.

212. See, e.g., Helfer, *Exiting Treaties*, *supra* note 83; Timothy L. Meyer, *Power, Exit Costs, and Renegotiation in International Law*, 51 HARV. INT’L L.J. 379 (2010).

ity and decreasing the global effectiveness of the agreement. Such formally legal but unresponsive actions do not fit easily into the international relations theory framework of cooperation and reputation. The model of cooperation is based on a prisoner's dilemma game (or a similar game-theoretic model) where the parties have a choice between cooperation and defection.<sup>213</sup> Creating a third option where states can eschew the policy outcomes the treaty seeks to advance yet avoid violating the terms of the agreement complicates the narrative of what cooperative activity entails.<sup>214</sup>

This complication is important for international relations theory. If states comply with international agreements because they want to maintain a good reputation as treaty partners, then what does the use of flexibility mechanisms mean for the international system's ability to support cooperation? Fundamentally, the way in which the reputation mechanism would work depends on the audience's beliefs about the significance of using flexibility mechanisms.<sup>215</sup> Although the flexibility literature does not discuss this issue, there are multiple ways in which the international audience could understand a state's decision to use such provisions. One possibility is that the audience may view the use of escape clauses, reservations, or exit provisions as a negative signal of cooperativeness.<sup>216</sup> Even though the state is acting within the legal confines of the agreement, making use of flexibility mechanisms runs counter to the goals of the regime. The state is not in violation of the treaty agreement, but it is failing to adhere to the preferred course of action that the treaty sets out, opting instead for an allowable, but less preferred course. In this framing, the reputation of the state as cooperative should suffer.

Alternatively, the audience could view the use of flexibility mechanisms as completely permissible because they are part of the political bargain.<sup>217</sup> The state has made a contract with other states and is sticking to the terms negotiated. That the use of escape clauses may be a less preferred means of complying with the treaty's requirements is of little moment; the state is only making use of the policy options that the treaty makes available. In this framing, a state's decision to make use of an escape clause, reservation, or exit option should have no reputational impact. So long as the state's actions conform to the requirements of the treaty, the state's actions do not send a negative signal, and the state maintains (or even improves) its reputation for cooperativeness.

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213. See generally GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 1.

214. For an effort to incorporate exit into a prisoner's dilemma type game, see Helfer, *Exiting Treaties*, *supra* note 83.

215. For a discussion of how the international system is a social construction, see Alexander Wendt, *Anarchy is What States Make of It: The Social Construction of Power Politics*, 46 INT'L ORG. 391 (1992).

216. For the view that reservations will hurt the state's reputation for cooperativeness, see generally Helfer, *Reservations*, *supra* note 1.

217. Swaine argues that a state's insistence on a reservation may be a positive signal of its cooperativeness in a treaty regime, but the reservation signals that the state will only agree to those provisions that it has the political will to implement. See Swaine, *supra* note 25.

Neither view is obviously correct—both views are viable social constructions—but the two understandings have very different implications for cooperation theory. If the audience views the use of the flexibility mechanisms as detrimental to cooperation (and thereby downgrades the state's reputation for cooperativeness), then this has a significant impact on international relations theory. The ability of reputational concerns to uphold agreements is diminished. If states can suffer reputational losses by using flexibility mechanisms, then reputational concerns do not support the actual texts of agreements, but a stricter view of appropriate policy action that is consistent with the treaty's aims and goals. This may undermine the agreement in the negotiation phase and the enforcement phase. In a situation where states believe that they cannot take advantage of flexibility mechanisms without suffering a reputational loss, then more states may be reluctant to join the treaty agreement if they do not anticipate that they will be able to comply with the goals of the agreement. For instance, a state may be less likely to join an investment agreement if it believes it will suffer a reputational loss if it makes use of an escape clause during an economic shock. While the treaty's escape clause formally gives the state the space to enact such a policy, it will not necessarily be viewed as a cooperative action, and thus the reputation of the state may nonetheless suffer.

At the enforcement end, a state may be more willing to violate an agreement if it is going to suffer a reputational loss for using a flexibility mechanism. For instance, if a state experiences a political or economic shock, it will have a choice between making use of a treaty's escape clause (if it exists) and simply violating the agreement. Should the state expect to suffer a reputational loss regardless of its choice—using the flexibility provision or violating the agreement—then the option to violate may be more attractive because the state will possess more policy discretion in the latter course. Even if there is a greater reputational loss for violations as compared to the use of the flexibility mechanism, the relevant analysis for the state will be the costs of violation versus the benefits of making use of the escape clause. At the margin, the fact that the escape clause entails reputational costs lowers the relative costs of violation as compared to a set of beliefs where the use of an escape clause is without reputational loss.

By contrast, if states can utilize flexibility provisions without suffering a reputational loss, then there is a different tradeoff. Governments may be more willing to sign onto treaty agreements, but they will have more discretion in their national policy choices. The overall effectiveness of the regime may be reduced—that is, the number of states that implement the preferred policies may be lower—but the treaty may have a greater influence over more states because more states will join the agreement and abide by the, albeit looser, bindings of the treaty.

This analysis does not attempt to resolve definitively what the social meaning of flexibility mechanisms will be. Rather, the goal here is to high-

light the links between the flexibility literature and cooperation theory that have thus far been generally neglected in both international relations and international law scholarship. But the discussions in this Article provide important insights into how the audience is likely to view flexibility mechanisms. Most importantly, the structure of the flexibility mechanism is likely to matter. If the consequences of using a flexibility mechanism are static, then the mechanism is more likely to be viewed as a price than as a sanction. The pricing approach indicates that there is not a reputational effect from using the flexibility mechanism—the ability to make use of the provision has been purchased. In contrast, the sanctioning approach indicates that there will be reputational sanctions in addition to the costs of using the flexibility provision.

## 2. *Reconceptualizing Pacta Sunt Servanda*

The flip side of institutional flexibility is the strict rule of international law that treaties are to be obeyed. This paper attempts to reconceptualize what *pacta sunt servanda* may mean for certain treaty regimes. The focus here is not entirely on obedience to a treaty's substantive rules, but on the treaty's framework as well, including its dispute resolution provisions and remedy regime.

First, this Article emphasizes that the parties to a treaty may have strong policy reasons for preferring compliance with second-order rules rather than first-order rules, particularly in economic issue areas. As political scientists have discussed, the parties may prefer a regime that is robust—capable of encouraging deep cooperation that will survive political and economic shocks—rather than one that has high levels of compliance but is fragile. For instance, the WTO is fundamentally a managed trade organization, in which parties bargain over trade concessions.<sup>218</sup> The resulting treaties are the negotiated balance of trade concessions, in which parties grant access to their national markets in return for access to others' markets. For the trade system's purposes, it is beneficial for the negotiating parties to stretch—that is, to agree to a greater range of concessions than they might be able to keep in future political or economic conditions. Because the future is uncertain, the governments do not know which of these concessions will be problematic and which will be achievable. Governments may be unwilling to agree to deep cooperation if they anticipate that their feet will be held to the fire with regards to all obligations.<sup>219</sup>

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218. As international trade economists frequently note, free trade theory posits that states will do better by liberalizing their individual markets, even if other states do not. See generally Paul Krugman, *What Should Trade Negotiators Negotiate About?* 35 J. ECON. LITERATURE 113 (1997). Instead of promoting unilateral liberalization, the GATT-WTO system effectively treats states' market barriers as bargaining chips, an asset that should be given away only for something of equivalent value. This bargaining system has led to incrementally greater global market liberalization but does so through merchantalist means.

219. Palmetier & Alexandrov, *supra* note 117, at 664–65.

By building a dispute resolution system into the agreement that can price noncompliance with substantive terms, the remedy regime can promote deeper cooperation *ex ante* by encouraging compliance, but allowing states the possibility to buy themselves out of the concessions that later become overly onerous. As Kenneth Dam noted decades ago with regard to the GATT system, “because of the economic nature of tariff concessions and the domestic political sensitivity inherently involved in trade issues, a system that made withdrawals of concessions impossible would tend to discourage the making of concessions in the first place. It is better, for example, that 100 commitments should be made and that ten should be withdrawn than that only fifty commitments should be made and that all of them should be kept.”<sup>220</sup>

The traditional interpretation of *pacta sunt servanda*—requiring states to comply with all of the concessions it offers even if a dispute resolution system is part of the treaty regime—could be detrimental to the goals of the trade system by discouraging states from stretching to achieve deeper cooperation. Along a similar line, the states creating the treaty regime may be attempting to recruit more states into the regime. The more severe the compliance rules, the higher the potential reputational costs of joining the regime. In short, there is a tradeoff between the depth of cooperation, the breadth of state involvement, and the strictness of our interpretation of the *pacta sunt servanda* requirement. A rigid understanding of the *pacta sunt servanda* requirement, demanding compliance with all substantive provisions all of the time, comes at a cost to international law. It may prevent states from engaging in more extensive cooperation by limiting the concessions states are willing to make and the regimes they are willing to join.

Second, this Article highlights how the parties (the negotiating states) select not only the treaty’s substantive terms, but also its dispute resolution system and remedy rules. Members of a treaty regime can select any remedial regime that they like. This is different from private parties bargaining under American contract law, where the parties take much of the contract regime—particularly the rule formally forbidding punitive damages for breach—as exogenous.<sup>221</sup> Instead, the lack of a sovereign set of rules regarding treaties in the international system allows the parties to draft any remedial provisions that they prefer. If the parties wish to create a system in which substantive obligations can be breached for a price, then the treaty can be created to do so. The entire treaty regime, not just the substantive provisions, will be a reflection of the parties’ preferences. Thus, for some treaty regimes, the principle of *pacta sunt servanda* can be understood as complying with the treaty’s framework, not necessarily obeying its substantive provisions, if the parties themselves have selected that structure.

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220. KENNETH W. DAM, *THE GATT: LAW AND INTERNATIONAL ECONOMIC ORGANIZATION* 80 (1970).

221. See *supra* note 65 and accompanying text.

## V. THE MATCHING (OR MISMATCHING) REMEDIES AND OBLIGATIONS

Formal remedies may or may not be additive to informal sanctions, and thus the creation of formal remedy regimes may increase or decrease the overall level of costs from noncompliance.<sup>222</sup> The idea that formal remedies may potentially decrease the overall level of costs is contrary to the prevailing account in international law that formal remedies build upon informal sanctions.<sup>223</sup> Yet recognizing the potential for an inverse relationship between formal remedies and reputational sanctions is important when designing a remedy regime. Most remedy regimes are designed to establish a certain level of compliance. The designers of a regime understand that member governments may deviate from the regime's substantive rules at some point in the future, and negotiators may or may not wish to deter all of these possible deviations. In establishing the regime's remedy rules, negotiators can attempt to establish a level of penalty that approximates the negotiating parties' view of when deviations should be permitted. Understanding whether the formal sanctions will work to supplement informal sanctions or will instead undermine informal sanctions is important to questions of remedy design.

Explicitly discussing the relationship between remedies and the binding nature of treaty obligations highlights the possibility that negotiators' attempts to harden international law may be counter-productive. When the negotiators do not actively consider the role of reputation in their remedial scheme—effectively discounting the possibility of a pricing effect—negotiators may set remedies at a sub-optimally low level. In many situations, negotiators may be better off avoiding a remedy regime altogether than compromising on a regime that provides some limited remedies, which are insufficient to deter breach.

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222. There is a methodological point here as well. This Article attempts to highlight how reputational concerns regarding breaches of international law are not independent of the broader regime in which the breach occurs. Simply stating that there has been a breach of international law does not provide enough context to enable observers to determine what the reputational consequences will be. This is relevant to a growing empirical examination of situations in which elected officials or citizens will support greater compliance with international law, in part due to reputational concerns. See, e.g., Michael Tomz, *Interests, Information, and the Domestic Politics of International Agreements* (July 2004) (unpublished manuscript), available at <http://www.stanford.edu/~tomz/working/Tomz2004a.pdf>; Tomz, *Preferences and Beliefs*, *supra* note 172. This empirical work is a notable and valuable addition to theoretical studies of reputation in international relations and international law. This Article underscores the importance of institutional context for the research design of these empirical projects. For instance, empirical studies that ask government officials or citizens whether they support a governmental policy that would contravene international law without discussing the broader institutional context may be misleading. The respondent's answer may be very different depending on whether or not the respondent understands that the regime provides for compensation for breach or other rebalancing. Consequently, divorcing the question of whether a respondent supports a governmental policy that would entail a breach of international law from the institutional design of the regime establishing the international law rules may bias the study by overestimating the respondent's expectation of the reputational costs.

223. GUZMAN, *HOW INTERNATIONAL LAW WORKS*, *supra* note 1, at 19; Tomz, *Preferences and Beliefs*, *supra* note 172. *But see* SCOTT & STEPHAN, *supra* note 1, at 580.

The risk of a mismatch between the enforcement goals of the treaty and the remedy regime is highest with international environmental agreements, but it is also present with human rights agreements. Many environmental agreements have already engaged a system of pricing as part of the substantive rules of the system. For instance, the Kyoto Protocol allows states to purchase emissions credits from other states in order to meet the treaty's substantive requirements of decreasing emissions.<sup>224</sup> If a state does not take sufficient measures to decrease its own emissions production to the specified levels, then it can purchase the difference from other states that have excess emissions reductions.<sup>225</sup> Naturally, what constitutes excess emissions reductions depends on the baseline that the state is provided in the treaty. The Kyoto Protocol intentionally provided some states, such as Russia and Ukraine, with "headroom" with respect to their emissions limits, such that they would be able to sell emissions credits to states with more restrictive baselines, such as Germany or Canada.<sup>226</sup> This decision to commodify emissions has been widely criticized by environmental groups, who object to the idea that states or firms can purchase the right to pollute. However, such measures have been supported by economists, who emphasize that commodification can lower the economic cost of pollution reduction.<sup>227</sup>

In the 2001 Marrakesh Accords, the members of the Kyoto Protocol created a set of second-order rules addressing compliance with the first-order rules.<sup>228</sup> The remedy regime also deals in quantifiable emissions levels: any state that fails to meet its multi-year emissions targets has the shortfall, times thirty percent, subtracted from its next multi-year emissions levels.<sup>229</sup> Whether this system is a price or a sanction depends on the perception of the audience. The nature of the issue area—providing a sustainable level of a public good—indicates that the rules should be mandatory—a failure to comply with the rules (particularly by a large number of states) could lead to serious environmental damage on a global scale. The remedy regime and the substantive rules, however, lean more towards a pricing system. The Kyoto Protocol makes emissions reductions available for purchase. Rather than a mandatory obligation to adopt the type of government policies that would

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224. RICHARD B. STEWART & JONATHAN B. WIENER, RECONSTRUCTING CLIMATE POLICY: BEYOND KYOTO 1 (2003). Negotiations regarding a successor agreement to Kyoto also include discussions of an emissions trading system.

225. Stavins, *supra* note 59, at 15.

226. STEWART & WEINER, *supra* note 224, at 1.

227. See *supra* note 60 and accompanying text.

228. JON HOVI, OLAV SCHRAM STOKKE & GEIR ULFSTEIN, IMPLEMENTING THE CLIMATE REGIME: INTERNATIONAL COMPLIANCE 3 (2005). The enforcement rules also demand that the breaching party (1) draft an action plan for how it will come into compliance and (2) be prohibited from selling emissions credits. *Id.* To the extent that the breaching state is a buyer of emissions credits, the thirty percent increase to the emissions shortfall is the most concrete deterrent to breach. The legal status of the enforcement provisions is uncertain. Japan and Russia resisted the idea that the enforcement system would be legally binding. Cathrine Hagem et al., *Enforcing the Kyoto Protocol: Sanctions and Strategic Behavior*, 33 ENERGY POL. 2112, 2112 n.1 (2005).

229. HOVI, STOKKE & ULFSTEIN, *supra* note 228, at 3.

lead to sustainable emissions levels, governments are free to overproduce emissions and buy their way out of their emissions restrictions by purchasing credits from other states. The remedy rules indicate a similar approach. If a government does not wish to purchase sufficient emissions credits this year, it can defer the payment until the following year at a set interest rate. The interest rate of thirty percent is high, indicating a punitive element, but a state can remain in compliance with the treaty regime by purchasing fewer credits now or more credits later.

Does a government bound to the Kyoto Protocol suffer a loss of reputation for cooperativeness if it breaches the agreement's substantive rules but complies with the remedy provisions? An immediate concern is whether the government will ultimately comply with the remedy by purchasing more credits or by undertaking more stringent environmental action in the future. Particularly in the environmental agreement context, where compliance with the remedy may be a multi-year process, the audience may be uncertain as to whether the breaching government plans to accept the remedy. But to the extent that the audience believes that the government will accept the remedy, does it matter to the audience whether the government buys emissions credits now or thirty percent more credits later? While the answer will depend on the beliefs of the audience, the system of emissions credits pricing most likely decreases the reputational costs of breaching Kyoto's substantive rules if the remedy is met. Already, member governments can buy their way to compliance through purchased emissions credits. The difference between buying some credits in this multi-year commitment period and buying more in the next multi-year commitment period seems closer to a financial calculation than a violation of a mandatory obligation.

Naturally, the designers of the Kyoto Protocol and the Marrakesh Accords could have decided that reliance on formal remedies, such as a thirty percent premium in emissions credits for any shortfall, was a better enforcement system than informal remedies. Even many dedicated environmentalists may believe that reliance on moral suasion and reputational concerns has not done enough to preserve the global atmospheric commons and that financial penalties may be more effective in encouraging governments to take action. Such an approach is completely reasonable. The issue addressed in this Article is the relationship between informal and formal remedies. By opting for a market-style system for first-order and second-order rule compliance, the Kyoto Protocol and the Marrakesh Accords may undermine the reputational costs to governments that fail to meet their emissions limits in any given commitment period. This may be a cost that the drafters are willing to accept in the hope of having more effective formal remedies, but the drafters should be aware of this cost. Specifically, treaty designers may need to increase the formal remedies to compensate for the decreased reputational losses associated with breach.

The possibility of a misalignment between the formal remedy and the mandatory nature of the substantive rules also exists in human rights regimes. Human rights agreements are likely to be viewed by the international audience as far more mandatory than economic agreements. Yet even within a human rights agreement, different rights have different social meanings: rules requiring that a state not indefinitely detain individuals without trial are likely to have more moral force than rules requiring the enforcement of intellectual property rights.<sup>230</sup> Many human rights agreements provide formal remedies and authorize certain courts to award those remedies. The most famous human rights court is the ECHR, which has jurisdiction over all states within the Council of Europe.<sup>231</sup> The ECHR offers a range of remedies, from “just satisfaction”—the court’s judgment that a breach of human rights obligations has taken place (yet no monetary award is dispensed)—to monetary awards intended to compensate the victim. While any breach of human rights obligations may come with a reputational loss for the breaching state, the award of monetary compensation may remove some of the reputational sting from the finding.

For instance, the Russian government has repeatedly breached the European Convention on Human Rights and has dutifully paid the required fine in each instance.<sup>232</sup> The ability to pay the fine, rather than changing its policy, has allowed Russia to adopt a pay-as-you-go approach to breaches of human rights obligations. These payments have kept Russia within the bounds of the Convention and thus prevented a more severe sanction, such as expulsion from the Council of Europe.<sup>233</sup> This analysis also indicates that remedies that are not meant to be compensatory, such as just satisfaction, may act as a sanction rather than a price. The just satisfaction remedy might be a wise option for a human rights court that lacks the remedies to deter breach but desires to brand the breaching government as a violator of important norms. The inability of the state to pay a remedy may actually increase the state’s reputational loss because the state cannot remediate its breach.

## VI. CONCLUSION

The creation of formal remedies is considered an unambiguous good for international law. For a field obsessed with the lack of enforcement, the

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230. See Laurence R. Helfer, *The New Innovation Frontier? Intellectual Property and the European Court of Human Rights*, 49 HARV. INT’L L.J. 1 (2008) (discussing the ECHR’s decisions interpreting intellectual property rights as part of the right to property protected in the European Convention on Human Rights).

231. *Id.* at 2.

232. Human Rights Watch, *Russia Country Summary* (Jan. 2012) (noting that “the ECtHR had issued more than 210 judgments holding Russia responsible for grave breaches of human rights in Chechnya. Russia continues to pay the required monetary compensation to victims. But it fails to meaningfully implement the core of the judgments, chiefly because it does not conduct effective investigations and hold perpetrators accountable”).

233. Pamela Jordan, *Does Membership Have Its Privileges?: Entrance into the Council of Europe and Compliance with Human Rights Norms*, 25 HUM. RIGHTS Q. 660, 680–88 (2003).

creation of international adjudicatory panels and the creation of “real” remedies can signify the seriousness of the international obligation. International law seems to approach domestic law in its access to independent adjudication and hard consequences for noncompliance. Yet the move towards international adjudication and remedies is a double-edged sword. The creation of remedies can diminish the system of informal remedies that currently supports international law. The conventional view is that formal sanctions will be additive to these informal sanctions—that the inclusion of informal sanctions will only increase the costs of breach. But an alternative relationship is also possible—that the move towards formal remedies will decrease access to informal remedies, including reputation. In some cases, the access to formal remedies will still be an “improvement” over the traditional approaches to international law enforcement in the sense that the costs of breach are higher with the addition of formal remedies. Yet in other circumstances, the costs of breach may be lower with formal remedies. In either case, calculating the overall cost of breach—necessary to the design of optimal remedy regimes—requires an understanding of how informal and formal sanctions interact.