



Investor-State Dispute Settlement (ISDS) State of play and prospects for reform

SUMMARY

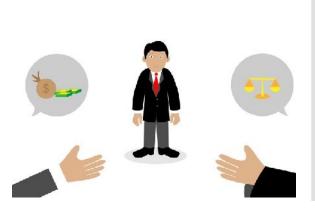
Investor-State Dispute Settlement (ISDS) mechanisms are found in more than 3 000 international investment treaties, but have been increasingly criticised in recent years.

International investment agreements, and the ISDS mechanism, were originally created to protect investors from arbitrary expropriation and ensure non-discriminatory treatment for foreign investments, in countries considered risky. In such countries, with the judiciary not fully independent from government, arbitration was considered a more neutral framework to ensure enforcement of the host state's obligations towards investors.

The progress made on comprehensive free trade agreements (FTAs) between the EU and Canada and the United States – in both cases including provisions for ISDS – has intensified discussion on the mechanism in the EU. A number of doubts exist with respect to the impartiality of arbitrators, while the relative broad interpretation given to the provision has been considered to have substantially reduced states' freedom to regulate, creating an imbalance between the investor's right to protection and the host state' sovereign right to regulate its market.

The EU supports ISDS arbitration in general, while recognising the need for its reform. Indeed a consensus seems to be emerging on systemic problems found in this increasingly used system. That has led the European Commission to propose some innovative provisions in the framework of negotiations on EU trade and investment agreements, but without calling into question the ISDS system itself.

This is an updated version of a briefing published in January 2014.



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Issue

Investor-State Dispute Settlement (ISDS) is a legal mechanism allowing an investor from one contracting state to an international investment agreement to bring a claim against another contracting state in which it has made an investment (also known as the host state), because relying on the national courts of the host country to enforce obligations in an investment agreement is not always easy, may be time-consuming or may even be impossible. ISDS was created to reduce the political risks related to rapidly increasing foreign investment, and make the commitments made by host states in investment treaties more easily enforceable. Its opponents say it is a 'toxic mechanism' or even a 'Trojan horse', enabling foreign companies to challenge public health, environmental and social protection laws that harm their profits.

The issue of ISDS has come to public attention in the EU with the completion of negotiations for a <u>Comprehensive Economic and Trade Agreement</u> (CETA) with Canada in October 2013, and the opening of negotiations on a <u>Transatlantic Trade and Investment Partnership Agreement</u> (TTIP), in July 2013.¹

The EU itself (through the Energy Charter Treaty), as well its Member States are party to around 1 400 agreements which provide for ISDS.

At the same time, some third countries² are in the process of revoking their investment treaties and conventions that include ISDS mechanisms, while Australia has announced that its future investment agreements will not contain ISDS provisions.

Since the entry into force of the Lisbon Treaty in 2009, <u>foreign investment policy</u> has been an exclusive EU competence. With reform of international arbitration seeming increasingly inevitable, the EU, given its overall economic weight, therefore has the potential to be a key player in discussions.

Main features of current ISDS regime

Legal basis

The legal bases for ISDS cases are found in more than 3 000 international investment agreements (IIA) concluded between parties to determine investors rights' in each others' territories. The vast majority of Bilateral Investment Agreements (BIT), and some plurilateral ones (including the Energy Charter Treaty), contain clauses providing for consent for arbitration in case of a dispute between host state and investor. Sometimes they also include alternative mechanisms, such as proceedings before domestic courts of the host state, or another procedure agreed by both parties to a dispute.

Investor protection standards

The scope of disputes covered varies from the broad 'all disputes concerning investments' to narrow, including specific types of disputes only.³

Commentators point to the **four main guarantees** that virtually all agreements provide to investors, establishing a largely uniform system of international investment protection:⁴

- Protection against **discrimination**. Under 'national treatment' (NT) and 'most favoured nation treatment' (MFN) clauses, a host government must treat foreign investors equally to national investors and the best-treated investors from abroad.
- Protection against expropriation without proper compensation. Expropriation can be either unlawful or lawful. Lawful expropriation is expropriation made for public purposes, following due process, is non-discriminatory and done with

compensation. The definition of compensation varies across treaties. Such provisions also apply to protection against 'indirect expropriation', which is interpreted as host government actions, often through regulations that have similar effect to expropriation. The main issue here is how much compensation must be given for lawful expropriation as well as define when 'indirect expropriation' takes place. Can any regulatory measure that affect the legitimate expectation of an investor lead to 'indirect expropriation' claims and therefore to a right to compensation?

- 'Fair and equitable treatment' (FET) for investors. This principle lacks a clear definition, and being frequently invoked by investors, this leaves wide room for interpretation to arbitrators. The term has been applied to a series of considerations including 'good faith', protecting investments from abusive acts of the host state, application of regulatory fairness and transparency as well as safeguarding investors' legitimate expectations.
- Protection of capital transfers, by banning host governments from restricting flows of capital.

BITs may also contain 'umbrella clauses' requiring the host state to respect any obligation assumed by it with regard to a specific investment (for example contractual obligations).

Traditionally, several legal instruments have been used by contracting parties in IIAs to preserve part of their right to regulate or limit benefits under BITs. These measures may include sector-specific exceptions, economic integration exceptions (REIO), general exceptions (such as for public order, security, health and morality), also common are exceptions for taxation or subsidies and public procurement. Moreover states have invoked provisions from the International Law Commission's 'Draft Articles on State Responsibility' such as the international public law concepts of 'force majeure' and of 'necessity'. The latter was invoked by Argentina in cases connected to its sovereign default. Notwithstanding these measures, countries have been worried about the potential effect of IIAs on the regulatory power of the state, in particular with reference to the effect of protections against 'indirect expropriation' and the FET principle.

Applicable rules

Arbitration tribunals operate most often under the rules established by the World Bank's <u>International Centre for Settlement of Investment Disputes</u> (ICSID) through the <u>Convention</u> on the Settlement of Investment Disputes between States and Nationals of other States (1965) and its Additional Facility. However many BITs leave to the parties the choice between the ICSID and other types of arbitration. The Arbitration Rules of 1979 (revised in <u>2010</u>) of the United Nations Commission on International Trade Law (<u>UNCITRAL</u>) is the second most used system. A few cases are also handled by the Permanent Court of Arbitration in The Hague, the London Court of International Arbitration, and by international chambers of commerce and regional arbitration centres.⁵

The stages of an ISDS procedure

There are common procedural steps under these different sets of rules:

- Notice of arbitration is usually sent by an investor to the host state.
- Both parties choose the arbitration tribunal and proceed to selection of arbitrators: usually each party chooses one, with the third appointed jointly to chair the tribunal.

- Proceedings, in which both parties are represented by teams of lawyers, may last several years.
- The award determines the amount of compensation, if so decided, and allocates legal costs. It is final and binding on the parties, but does not create a binding precedent applicable in other cases, although in practice tribunals often refer to earlier arbitration decisions.⁶

Statistical overview of cases

Since the majority of arbitration fora do not have a public register of cases, the statistical data below are based on 'known cases', as set out in <u>reports</u> of the United Nations Conference on Trade and Development (UNCTAD).

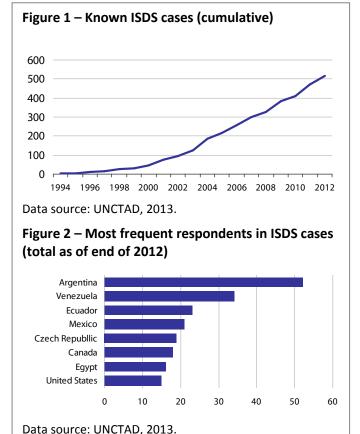
The year 2012 saw the highest number ever, 58, of new treaty-based disputes registered, continuing the growth trend.

The majority, 64%, of these 58 new cases originated in developed countries, while the respondents in 66% of cases were developing or emerging countries.

Latin America countries have to face ISDS cases most frequently, while the USA is the origin of 24% of all claimants. However, 2012 saw at least eight new intra-EU investment disputes, bringing total intra-EU cases up to 59.

UNCTAD statistics on investor-state dispute settlement cases show that a majority of cases are decided in favour of the host government (of all the cases concluded up to 2012, 42% found in favour of the state, 31% in favour of the investor and 27% were settled before an award was made).

The broad scope of governmental measures challenged by investors includes changes in the regulatory framework in areas such as gas, nuclear energy, telecommunications, marketing and tax measures. Among the



treaties providing the legal basis for cases, the North American Free Trade Agreement (NAFTA), the Energy Charter Treaty and the Argentina-USA BIT were the most frequent.

According to UNCTAD <u>reporting</u> from 2012, there were at least three cases in which investors have challenged **environmental measures** introduced by governments. Swedish energy company <u>Vattenfall</u> is suing Germany, under the Energy Charter Treaty over its decision to phase out nuclear energy. Canada was put on notice of a claim challenging the Ontario government's moratorium on offshore wind farms by Windstream Energy LLC, and by Lone Pine Resources regarding the government of Quebec's ban on oil and gas activities in certain areas.

Systemic challenges and implementation issues

Both NGOs and international organisations' experts point to a series of issues undermining the current ISDS system.

Inconsistency and unpredictability of decisions

Observers <u>note</u> that IIAs contain loopholes and vague formulation of major provisions, so enabling abuses (e.g. 'nationality shopping' by companies which create subsidiaries abroad specifically to take advantage of IIAs) and leave a wide margin of interpretation to arbitrators.

The resultant **divergent interpretation** of similar or identical IIA provisions has led to uncertainty about the meaning of treaty obligations and a lack of predictability. The consequences of divergent or even erroneous awards are aggravated by the **absence of the possibility of appeal**.

Lack of transparency

ISDS procedures are in most cases confidential. The ICSID is the most 'open' of the arbitration fora, publishing most awards and a list of cases. However not all awards are published, nor the submissions of the parties. Other organisations involved in arbitration are even less transparent. One of the most secretive is the International Chamber of Commerce, where all details of individual cases are <u>secret</u>. Except for ICSID, which requires the publication of some limited information about cases, other sets of rules originally developed to deal with commercial disputes between private parties, have no provisions on transparency.⁷

Lack of independence and impartiality

Except for conditions related to nationality included in some IIAs, very few agreements address the question of conflicts of interest and impartiality of arbitrators, which is often the subject of criticism.⁸

Arbitrators, appointed case by case by parties, are mostly male (95%) and from Europe and North America. They have also often acted as counsel in other cases: 50% for investors, and 10% for states. This role-swapping, among a relatively small number of elite investment lawyers, is sometimes seen as leading to mutual corporate solidarity that can lead to awards through 'unhealthy compromises'. A growing number of challenges by the opposing party to proposed arbitrators indicates that the candidate pool is seen as biased. 11

A <u>Corporate Europe Observatory</u> report concludes that the arbitration industry, far from being the passive beneficiary of the ISDS system, is its active promoter. There are strong personal and commercial ties between investment lawyers, from a handful of specialised law firms and the multinational companies which sometimes even appoint them to their boards. As well as acting in different roles (arbitrator, counsel, expert) in different cases, they are often prominent academic experts in the field, and in control of specialist journals. This makes investment lawyers influential advocates of the ISDS system.

Costs

Under NAFTA alone, the series of investor-state cases has given rise to the payment of over US\$350 million in compensation. 12

Average legal and arbitration costs of a case are US\$8 million, with the main part being the cost of legal representation and experts (80% of the total). Law firms charge as much as US\$1 000 per hour, per lawyer, with several on each case. The arbitrators' fees are also high, at an average of US\$3 000 a day, plus travel and subsistence. As a case of US\$3 000 a day, plus travel and subsistence.

The high costs of arbitration explain to some extent the growing phenomenon of 'third-party funding of claims'. Investment firms (banks, hedge funds and insurance

companies) offer to invest in a company's cases in exchange for a share (from 20% to 50%) of the potential final compensation awarded. By reducing the financial risk for companies, such 'third-party funding' contributes to an increase in 'frivolous cases' for which states still bear full legal costs.

NGO observers also deplore the huge public costs of the compensation ordered to be paid to investors by states. The largest known award hit <u>Ecuador</u> in October 2012: US\$2.4 billion.

'Chilling effect' on state regulatory powers

Although arbitration tribunals have no authority to force a government to change the law put into question by the investor, it has been argued by some commentators that some governments actually step back to avoid having to pay compensation. The larger question raised by some is whether three individuals appointed on an ad hoc basis have enough legitimacy to assess the validity of sovereign state law, and de facto restrict the policy choices made by democratically elected legislators. 16

Reforms and alternatives

There are two types of response to current criticism of the ISDS system. Some, including the arbitration industry as well as the European Commission, are ready to accept some reforms as long as they do not imply fundamental redesign of the system. Others, including some <u>academics</u> and NGO representatives, would opt for an alternative to the current ISDS system.

Alternatives

Renunciation of existing IIAs

A <u>2010 appeal</u> from dozens of academics calls on states to renegotiate or withdraw their IIAs with a view to replacing ISDS, seen as 'hampering the ability of governments to act for their people in response to the concerns of human development and environmental sustainability'. International organisations were asked to stop promoting the current system and look at alternatives such as **private risk insurance** and **contract-based arbitration**.

International Investment Court

According to some scholars,¹⁷ an **International Investment Court** would be the best option to replace the current ISDS system, judged to lack basic standards of openness and independence, as well as being structurally biased towards companies.

An International Investment Court established by a group of states linked by IIAs would have the advantage of replacing private arbitrators, appointed case by case, with judges nominated for set terms, a recognised prerequisite for judicial independence.

A June 2013 <u>UNCTAD note on reform of ISDS</u> recognised that this solution would contribute to resolving some of the current system's major problems. It would ensure legitimacy and transparency of the system; facilitate consistency in judgments and the independence of adjudicators.

However some scholars and arbitrators stress that any centralised dispute resolution institution would continue the danger of enlarging its jurisprudential powers, with which states may not agree, thus posing a new problem of legitimacy. ¹⁸

Options for reform

Several major reforms are advocated to improve the existing system.

Improving transparency

Ensuring public access to proceedings and awards could be achieved in two ways:

- Investment treaties, like the recent <u>EU-Canada CETA</u>, can include transparency obligations directly in their text.
- A new treaty could add to existing arbitration rules. The <u>Rules on Transparency</u>, adopted by UNCITRAL in July 2013, and which came into effect on 1 April 2014, are a step in this direction. For the time being, the new rules will only apply to cases using UNCITRAL rules and initiated under investment treaties concluded after 1 April 2014. However UNCITRAL has announced the start of work on a convention to apply the new rules to existing investment treaties too. The CETA draft rules allow for the possible application of both UNCITRAL arbitration rules and the ICSID Convention and Additional Facility rules.

Introducing the possibility of appeal

A standing body with competence to receive appeals would provide the possibility to correct erroneous awards and enhance the predictability of the law. Some IIAs contain provisions on the opening of negotiations to create such an appeal mechanism, but none has yet been started. ¹⁹ This approach would, however, further increase the length and costs of proceedings.

The ISDS procedure as currently proposed would include several stages: first, consultation, second, mediation and, only after that, arbitration. Each of the stages would have a set time limit. The draft provisions include the possibility to ask for revision or annulment of an arbitration award.

Restricting access to ISDS

This option aims to limit the use of ISDS by:

- Excluding certain types of claims from its scope.
- Redefining the notion of investor (to avoid 'nationality shopping').
- Introducing sector-specific exceptions to some substantive provisions. For example, the CETA draft does not apply the provisions on establishment to the audiovisual sector, or the 'exception to establishment' rule and non-discrimination rules to air services and aircraft-related industries and services. Exceptions for public procurement, subsidies and preferential trade agreements were also added with respect to several obligations.
- Introducing the requirement to exhaust local remedies (in domestic courts) before arbitration.

Proposals for reforms aimed at restricting the parties' freedom to select the arbitrators (all arbitrators chosen jointly, or appointed by a neutral body) have encountered heavy criticism from arbitrators. So too have all proposals that undermine any of the fundamental pillars of the current system (freedom of disputing parties to choose arbitrators, avoidance of domestic courts, external enforcement of awards). ²⁰

Involving other areas of international law

Civil society calls for human rights and environmental obligations of states to be a major element to be taken into account in the settling of investor-state disputes.²¹ This could be achieved by including in IIAs provisions regarding sustainable development and human rights, as well as health policy and national security.²²

Regulatory power of the state and CETA

The draft provisions in CETA try to address fears about the limitation of states' regulatory powers through investment protection provisions. Mainly, it does so by restricting the scope of certain definitions. In particular, the annex to Article X(11), redefines the scope of 'indirect expropriation', by listing some of the factors to be considered in order to assess the existence of indirect expropriation. It clarifies that the adverse economic impact of a regulatory measure cannot per se be considered as 'indirect expropriation', and that the object, context and, most importantly, intent of the measure are to be considered. Moreover the draft provision provides that nondiscriminatory regulatory measures taken for a legitimate public objective cannot be considered as indirect expropriation, except in rare cases where the measure is considered disproportionate to achieving the said objective and its effects are so severe that they appear manifestly excessive. Clearer definitions are also used to limit the scope of the FET principle. The draft Article X(9) containing FET lists the possible breaches of the principles. This seems to be an exhaustive list as the article states that contracting parties shall accord '... fair and equitable treatment in accordance with paragraphs 2 to 6', which list all the possible breaches. The draft provision continues by saying that 'the parties shall regularly (...) review the content of the obligation to provide fair and equitable treatment'. The need to revise the content of the obligation shows a desire to consider the list as an exhaustive list of breaches that define the content of the FET. Article X(9) also defines the context of the legitimate expectation claim and gives to the principle of 'full protection and security' its historical meaning, of physical security of investors and the investments covered.

EU institutions

Council

The Council of the EU stresses that the new legal framework should not negatively affect investor protection and guarantees under existing BITs. The main pillars of future EU investment agreements should remain the current protections of IIAs, including the ISDS mechanism.²³

European Parliament

Parliament's 6 April 2011 <u>resolution</u> on the future of European international investment policy acknowledges that in spite of generally positive experience with ISDS, changes must be introduced. These should include measures to improve its transparency, possibilities of appeal and obligations to exhaust local judicial remedies. In general terms, a balance must be established between investor protection and the capacity of public intervention. MEPs called on the Commission to include in all future IIAs clauses protecting the right of parties to regulate in such sensitive areas as national security, the environment, public health, workers' and consumer rights, industrial policy and cultural diversity. A corporate responsibility clause should also be included. Parliament also expressed its deep concern at the margin of interpretation left to arbitrators as a result of the vague definition of investor protection principles.

European Commission

The European Commission, strongly in favour of ISDS in general, has taken into consideration some of the EP's demands aimed at rebalancing the system. It <u>published</u> in October and November 2013 a series of papers on ISDS in general²⁴ and on CETA and TTIP in particular:²⁵

• Clarifying and more precisely defining the basic guarantees provided to investors, to

limit the margin of interpretation (incl. clarifications to the key substantive provisions, which are also the most often invoked by investors when bringing claims under the ISDS system).

- Improving the transparency of ISDS, by <u>supporting</u> the UNCITRAL rules on transparency (public availability of documents, access to hearings and possibility for NGOs to make submissions).
- Obligatory code of conduct for arbitrators, to tackle the problem of conflicts of interest.
- Selection of all arbitrators from a predefined list and with the consent of both parties.
- Creation of an appeal mechanism.
- Introducing safeguard clauses for states to allow them to agree jointly how to interpret the investment provisions.

These measures, already included in the Canada CETA, would be promoted in all future EU trade and investment agreements, albeit negotiated on a case-by-case basis. The Commission has concluded the <u>public consultation</u> on ISDS provisions in the framework of TTIP and is committed to find a balance between the protection of investors and the legitimate right of States to regulate following the lines adopted in the CETA draft.

In November 2013, informal trilogues started on a proposal relevant to ISDS issues: The ISDS financial responsibility regulation (2012/0163(COD)) would create the framework for managing the financial responsibility linked to ISDS cases under agreements to which the EU is party. The proposed rules determining the distribution of roles and responsibilities between the EU and the Member States, and dealing with its budgetary implications, were substantially amended by the EP in May 2013, and referred back to the International Trade Committee.

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