SUMMARY

Investor-State Dispute Settlement mechanisms are found in more than 3 000 international investment treaties, but have been increasingly criticised in recent years. Their advocates defend them as a depoliticised neutral system to resolve disputes between foreign investors and host states.

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. Some critics have no hesitation in calling it a "toxic mechanism", which empowers corporations to the detriment of sovereign states' courts and parliament. Others focus more on an elite arbitration industry that promotes ISDS, in particular through its control of the editorial boards of international law journals covering the field.

The EU supports ISDS arbitration in general, while recognising the need for its reform. Indeed a consensus seems to be emerging on systemic problems faced by 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.

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Issue
Investor-State Dispute Settlement (ISDS) is a legal mechanism allowing an investor from another country to bring a claim against a state in which it has made an investment, because relying on the national courts of the host country to enforce obligations in an investment agreement is not always easy 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 Comprehensive Economic and Trade Agreement (CETA) with Canada in October 2013, and the opening of negotiations on a Transatlantic Trade and Investment Partnership Agreement, 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, foreign investment policy 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" and "most favoured nation treatment" 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. This also includes protection against "indirect expropriation", interpreted as host government actions,
often through regulations, that significantly reduce an investment's value.

- Protection against "unfair and inequitable treatment". The lack of a clear definition of this term, frequently invoked by investors, leaves wide room for interpretation to arbitrators.

- Protection of capital transfers, by banning host governments from restricting flows of capital.

**Applicable rules**

Arbitration tribunals operate most often under the rules established by the World Bank's *International Centre for Settlement of Investment Disputes* (ICSID) through the *Convention 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 type of arbitration. The Arbitration Rules of 1979 (revised in 2010) of the United Nations Commission on International Trade Law (UNCITRAL) 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 reports 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 reporting from 2012, there were at least three cases in which investors have challenged environmental measures introduced by governments. Swedish energy company Vattenfall 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 note 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 secret. 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.\textsuperscript{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\textsuperscript{9} of elite investment lawyers, is sometimes seen as leading to mutual corporate solidarity that can lead to awards through "unhealthy compromises".\textsuperscript{10} A growing number of challenges by the opposing party to proposed arbitrators indicates that the candidate pool is seen as biased.\textsuperscript{11}

A Corporate Europe Observatory 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.\textsuperscript{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).\textsuperscript{13} 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.\textsuperscript{14}

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 Ecuador 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.\textsuperscript{15} 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.\textsuperscript{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 academics and NGO representatives, would opt for an alternative to the current ISDS system.

Alternatives

Renunciation of existing IIAs

A [2010 appeal](#) 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, 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 [UNCTAD note on reform of ISDS](#) 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.

Options for reform

Several main 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 [EU-Canada CETA](#), can include transparency obligations directly in their text.
- A new treaty could add to existing arbitration rules. The [Rules on Transparency](#), adopted by UNCITRAL in July 2013, and due to come 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.

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.\textsuperscript{19} This approach would, however, further increase the length and costs of proceedings.

\textit{Restricting the access to ISDS}

This option aims to limit the use of ISDS by:

- Excluding certain type of claims from its scope.
- Redefining the notion of investor (to avoid "nationality shopping").
- 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).\textsuperscript{20}

\textit{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.\textsuperscript{21} This could be achieved by including in IIAs provisions regarding sustainable development, human rights as well as health policy and national security.\textsuperscript{22}

\textbf{EU institutions}

\textbf{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.\textsuperscript{23}

\textbf{European Parliament}

Parliament's 11 April 2011 \textit{resolution} 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.

\textbf{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 published in October and November 2013 a series of papers on ISDS in general\textsuperscript{24} and on CETA in particular:\textsuperscript{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 supporting 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. In addition, on 21 January 2014, when announcing a public consultation on ISDS provisions in a Transatlantic Trade and Investment Partnership, the Commission declared itself willing to include in the text of an agreement explicit reference to a state’s rights to regulate in the public interest.

References

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Endnotes

1 Investment Policy Monitor No 11 /UNCTAD, November 2013.
2 In March 2013, Ecuador revoked its investment treaty with the US. Ecuador (2009), Bolivia (2007) and Venezuela (2012) have renounced the ICSID Convention. In 2013 South Africa notified the termination of its BITs with Spain, the Netherlands, Germany and Switzerland, and in 2012 those with Belgium and Luxembourg.
3 New UNCITRAL arbitration rules on transparency: application, context and next steps/ August 2013, IISD, p. 6.
Just 15 lawyers acted as arbitrators in 55% of all cases, and 75% of all “big” ones (with compensation of over US$4 billion).


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