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REFORMING THE INVESTOR-STATE DISPUTE SETTLEMENT SYSTEM: EXPLORING ALTERNATIVE MECHANISMS

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Introduction

Investor-State Dispute Settlement ["**ISDS**"] is a legal mechanism that provides a forum other than that of the judicial system of the country where the concerned dispute has to be settled between the investors and the host state.[1] ISDS provisions have become a staple in International Investment Agreements ["**IIAs**"] in establishing neutral, independent and efficient resolution of disputes. The ISDS system responds to domestic deficiencies by providing foreign investors the ability to access international arbitration against the host state for non-compliance with obligations under IIAs.[2] By agreeing to ISDS provisions in treaties, host countries had hoped to provide foreign investors with a neutral forum so as to prevent any discrimination, and to provide fair and equitable treatment.[3]

ISDS' primary objective is to stimulate foreign investment by offering international investors an assurance that their property and rights would be protected. ISDS provisions have been increasingly adopted by developing countries having inexperienced or unfamiliar legal systems[4] since they were the most in need of foreign investments. An absence of complex legal systems in developing nations had reduced the interest in investing in that country since the risk of investment would be higher owing

[1] The Max Planck Encyclopedia of Public International Law (Oxford University Press 2010) <www.mpepil.com>.
[2] Stephan W. Schill, 'Reforming Investor-State Dispute Settlement (ISDS): Conceptual Framework and Options for the Way Forward' (E15Initiative, International Centre for Trade and Sustainable Development and World Economic Forum 2015).
[3] Gary Clyde Hufbauer, 'Investor-State Dispute Settlement' in Kimberly Ann Elliott and others (eds), *Assessing the Trans-Pacific Partnership, Volume I: Market Access and Sectoral Issues* (Peterson Institute for International Economics 2016).
[4] The Facts on Investor-State Dispute Settlement' (*The USTR Archives*, March 2014) <https://ustr.gov/about-us/policy-offices/press-office/blog/2014/March/Facts-Investor-State%20Dispute-Settlement-Safeguarding-Public-Interest-Protecting-Investors> accessed 23 February 2024.

to the lack of suitable legal protection.[5] Therefore, the use of the ISDS mechanism has increased considerably with globalisation as investment protection has become paramount while formulating a nation's foreign direct investment policies.[6]

Criticism of the ISDS system

The existence of arbitral tribunals that operate in a manner above the international human rights framework poses the main danger to a democratic and fair international order. The issue that arises with the ISDS system is of corporate arbitrators who have had their independence compromised due to conflicts of interest.[7] A growing number of tribunals uphold profit over human rights.[8] The confidential nature of these arbitrations adds to the growing concern since these awards are often not publicised.[9]

One such criticism is that of the regulatory chill induced by ISDS as it prevents governments from acting quickly and effectively to regulate in the public interest.[10] While ISDS has no direct effect on laws governing health and the environment, ISDS does impact on the way in which host states exercise their regulatory powers.[11] Governments face significant financial risks and face difficulties in predicting the results, thus having to pay damages to the tune of hundreds of millions, and in some cases, billions of dollars.

In *Philip Morris Asia v Australia*,[12] it had been alleged that Australia's requirement to introduce unit packaging for tobacco constituted an expropriation of its Australian investment. In response, the Australian government has issued a trade policy statement in 2011 stating that the country would not agree to ISDS in its future treaties.

In *Vattenfall AB v Germany*,[13] the Swedish energy company Vattenfall sued Germany under the Energy Charter Treaty for 1.4 billion euros in damages. A settlement was reached only after Germany had agreed to lower its environmental regulations, thus adversely affecting the Elbe River

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[5] Emily Osmanski, 'Investor-State Dispute Settlement: Is There a Better Alternative' [2018] 43 Brook. J. Intl. L. 639, 664.

[6] Marta Latek and Laura Puccio, 'Investor-to-State Dispute Settlement (ISDS): State of Play and Prospects for Reform' (PE 545.736, European Parliamentary Research Service 2015) 2.

[7] Pia Eberhardt and Cecilia Olivet, *Profiting from Injustice: How Law Firms, Arbitrators and Financiers are Fuelling an Investment Arbitration Boom* (Corporate Europe Observatory and Transnational Institute 2012).

[8] European Centre for Constitutional and Human Rights, 'Human rights Inapplicable in International Investment Arbitration?' (2012).

[9] UNCTAD, 'IIA Issues Note: Recent Trends in IIAS and ISDS' (2015) UNCTAD/WEB/DIAE/PCB/2015/1.

[10] Kyla Tienhaara, 'Regulatory Chill and the Threat of Arbitration: A View from Political Sciences' in Chester Brown and Kate Miles (eds), *Evolution in Investment Treaty Law and Arbitration* (Cambridge University Press 2011) 606, 615.

[11] Jonathan Bonnitcha, *Substantive Protection under Investment Treaties: A Legal and Economic Analysis* (Cambridge University Press 2014) 6, 114.

[12] *Philip Morris Asia Ltd. v The Commonwealth of Australia* (UNCITRAL) (2015) PCA Case No. 2012-12.

[13] *Vattenfall AB & Ors. v Federal Republic of Germany* [2021] ICSID Case No. ARB/12/12.

and its ecosystem. Following the German citizens' demand to shut down nuclear power plants in the aftermath of the Fukushima accident, the German Government decided to phase out the use of nuclear energy. Currently, Vattenfall is claiming 4 billion in damages.

Another major criticism is the lack of independence of arbitrators in the ISDS system. First, an increasing number of challenges to arbitrator appointments creates the appearance of bias.[14] If an arbitrator survives any challenges to appointment, they will be able to challenge the final award by writing a dissenting opinion. However, the recent proliferation of dissenting opinions raises concerns that arbitrators are not impartial, especially since dissenters are almost always appointed by the losing party. In fact, nearly all dissents favour the party that appointed the dissenting arbitrator, thus raising concerns about arbitrator neutrality.[15]

Scepticism of arbitrators' neutrality, which grows as dissents grow, becomes exacerbated by annulments of arbitral awards which are sometimes based on the rationales provided by dissenting arbitrators. In *Occidental Petroleum v Ecuador*,[16] the award was annulled due to the reduction of seven hundred million dollars in damages, the highest amount ever annulled by the International Centre for Settlement of Investment Disputes ["**ICSID**"], which partially upheld an arbitrator's dissent. ISDS has faced unprecedented criticism from public officials, academics, and arbitration professionals around the world.[17] The criticism ranges from concerns about procedural fairness to doubts about the democratic power to legislate. Thus, there is a necessity to explore other alternatives in light of these criticisms.

Ongoing reform of ISDS

For almost two decades, the United Nations Conference on Trade and Development ["**UNCTAD**"] has advocated for reforms to investment treaties to better serve the goals of "inclusive growth and sustainable development". One of the primary goals of this initiative has been to reform ISDS to overcome its "legitimacy crisis". UNCTAD's reform goal extends beyond suggesting improvements to ISDS. Negotiations regarding ISDS reform are being undertaken by the United Nations Commission on International Trade Law ["**UNCITRAL**"] through its Working Group III ["**WGIII**"].

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[14] *Fabrica de Vidrios Los Andes, C.A. & Anr. v Bolivarian Republic of Venezuela* (Decision on the Proposal to Disqualify L. Yves Fortier, Q.C., Arbitrator) [2016] ICSID Case No. ARB/12/21; *ConocoPhillips Petrozuata B.V. & Ors. v Bolivarian Republic of Venezuela* (Decision on the Proposal to Disqualify L. Yves Fortier, Q.C., Arbitrator) [2016] ICSID Case No. ARB/07/30.

[15] Albert Jan van den Berg, 'Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration' in Mahnoush H. Arsanjani and others (eds), *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman* (Brill Nijhoff 2011).

[16] *Occidental Petroleum Corp. & Anr. v The Republic of Ecuador* [2012] ICSID Case No. ARB/06/11.

[17] Gus van Harten, *Investment Treaty Arbitration and Public Law* (OUP 2007) 122.

This attempt to build a multilateral solution to the growing dissatisfaction with the existing condition of the international investment governance framework, and particularly, the impact of "old generation" treaties which are the source of the majority of ISDS cases.[18]

While it has developed a Policy Framework for a "new generation" of international investment policies, the five principles for sustainable international investment – safeguarding the right to regulate, reforming ISDS, promoting investment for sustainable development, encouraging investor responsibility and enabling consistency in a country's investment national and international policies, and list of IIA reform options encompass a wide range of options to "re-calibrate" the need to protect the States' right to regulate while also safeguarding incoming Foreign Direct Investment ["**FDI**"].[19]

ICSID has already begun reforming its ISDS mechanism through its most recent amendment to its Arbitration Rules. The objective of this effort has been to modernise ICSID's rules through increasing experience, reducing time and costs, expanding the selection of available dispute resolution mechanisms, and improving process efficiency and transparency while maintaining procedural parity between investors and respondent States.[20]

In order to address the concerns regarding rule of law, the Arbitration Rules, 2022 provide for greater transparency with respect to third party funding, new procedures for the dismissal of claims in cases of manifest lack of merit, consolidation or coordination of claims, releasing excerpts from awards to the public, orders of security for costs on parties, and fixing the time limits for procedures.[21] These changes, however, are mainly confined to making ISDS more efficient, cost-effective, and a preferred choice for its stakeholders.

Analysing alternatives to the ISDS system

i. *State-to-State Dispute Settlement*

This mechanism allows states to directly raise a claim against another state on behalf of their national who is an investor in the other state. Many investment treaties currently include State-to-State dispute settlement clauses that enable states to submit claims against their treaty counterparts for investor

[18] Sofia Balino, 'UN Negotiations to Reform Investor-State Arbitration Reach Critical Juncture' (*International Institute for Sustainable Development*, 30 April 2021) <https://www.iisd.org/articles/insight/un-negotiations-reform-investor-state-arbitration-reach-critical-juncture> accessed 29 September 2024.
[19] UNCTAD, *International Investment Agreements Reform Accelerator* (United Nations 2020).
[20] 'Working Paper #4: Proposals for Amendment of the ICSID Rules' (2020) ICSID <https://icsid.worldbank.org/sites/default/files/amendments/WP_4_Vol_1_En.pdf> accessed 24 September 2024; 'Working Paper # 5: Proposals: for Amendment of the ICSID Rules' (2021) ICSID <https://icsid.worldbank.org/sites/default/files/publications/WP%205-Volume1-ENG-FINAL.pdf> accessed 24 February 2024.
[21] 'ICSID Arbitration Rules' (ICSID Convention, Regulations and Rules, ICSID 2022).

harm. These dispute resolution clauses exist individually in certain treaties but are often found in tandem with an ISDS clause in the investment treaty.[22] This mechanism has already been adopted by Brazil, whose IIAs authorize only State-to-State dispute settlement, and is evident in other investment treaties that eliminate the need for ISDS, such as the United States-Mexico-Canada Agreement [“**USMCA**”], the Australia-United States Free Trade Agreement, the European Union-China Investment Agreement, and the European Union-United Kingdom Trade and Co-operation Agreement.[23]

In addition to allowing the investor to remain anonymous, state-to-state proceedings could be utilised to obtain a declaratory judgment that a certain domestic measure by the host state violates the treaty. This, in turn, may aid in the advancement of domestic reform for the benefit of a broader class of investors, and merely not the claimants. It can better account for the larger interests claimed to be protected by treaties’ provisions on the environment, labour, human rights, and governance. However, there is a possibility of decline in the FDI flows, politicisation of the dispute, and reduced number of claims from investors as a result of decrease in the ability of investors to secure financial awards.[24]

ii. *Multilateral Investment Court*

A multilateral investment court could potentially resolve most of the criticisms levelled against ISDS including the problem of inconsistency in application of case laws, multiplicity of proceedings, lack of appellate review, lack of transparency, diversity and independence of tribunals, and lengthy and expensive proceedings.[25] It would consist of a permanent panel of judges appointed on a full-time basis for six-to-nine-year terms. Additionally, it would be complimented by an appellate tribunal serving for the same duration. IIAs that have been recently entered into by the European Union with Canada, Singapore, and Vietnam contain provisions for the establishment of such a court.[26]

However, such a court would take away the most appealing aspect of ISDS, i.e., party autonomy to select arbitrators. States would be in a position to appoint all judges, thereby, tilting the balance in favour of the respondent States. It would noticeably curtail investor rights, greatly increase respondent States’ right to regulate, and subject arbitral discretion to binding inter-State party interpretations.[27]

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[22] Nathalie Bernasconi-Osterwalder, ‘IISD Best Practices Series: State-State Dispute Settlement in Investment Treaties’ (2014).
[23] José E. Alvarez, ‘ISDS Reform: The Long View’ (2021) 36 ICSID Rev-FILJ 253, 277.
[24] ibid.
[25] UNGA ‘Possible Reform of Investor–State Dispute Settlement: Submission from the European Union and its Member States’ UNCITRAL WG III 37th Session UN Doc A/CN.9/WG.III/WP.159 (2019).
[26] Comprehensive and Economic Trade Agreement (Canada-EU) (30 October 2016), art 8.9; EU-Vietnam Investment Protection Agreement (30 June 2019), art 3.41.
[27] José E. Alvarez, ‘Is the Trans-Pacific Partnership’s Investment Chapter the New “Gold Standard”?’ (2016) 47 Vic. U. Wellingt. L. Rev. 503.

The system is also unprecedented and raises significant questions regarding the legitimacy of the award. These concerns may be resolved by establishing "an assembly of state parties" who could control the evolution and interpretation of the IIA provisions to readjust the balance of rights. Since it cannot function like the World Trade Organization's dispute settlement body as there are no singular covered agreements that apply to all countries, the court system could benefit from the appointment of Joint Committees as part of the IIAs who could issue binding interpretations of investor protection standards.[28]

iii. *Appellate Mechanism*

Countries have also proposed for the introduction of a permanent appeals mechanism as a way to resolve several significant issues in ISDS.[29] Such a mechanism would be crucial in promoting the use of the rule of law in the resolution of conflicts between investors and States. It could enhance legal requirements for the resolution of investment disputes, boost error-correcting processes, and impose constraints on the judges' conduct.

Additionally, it would encourage increased procedural standardisation and reasoning which could decrease the abuse of rights by disputing parties. However, there exists no consensus regarding the scope of this appellate review or the method to establish it.[30] Similar to the multilateral investment court system, many concerns can be raised regarding the legitimacy of the decisions after review.[31]

iv. *Curtailing access to ISDS*

IIAs could also contain provisions that would limit the kind of claims that can be presented to investment arbitration or set onerous requirements for investment arbitration. An example of this is the 2016 Indian Model Bilateral Investment Treaty which imposes a requirement for a five-year exhaustion of local remedies to be fulfilled along with a number of formidable restrictions to filing an investor-State claim. Provisions of the USMCA also require certain investors in either Mexico or the United States to exhaust their local remedies before opting for ISDS.

However, it is not uncommon for contemporary IIAs to preclude access to ISDS when the claims involve government procurement and subsidies, services provided in public interest, and goods

[28] Schill (n 2).
[29] UNGA 'Possible Reform of Investor–State Dispute Settlement: Submission from the Government of China' UNCITRAL WG III 38th Session UN Doc A/CN.9/WG.III/WP.177 (2019).
[30] UNGA 'Possible Reform of investor–State Dispute Settlement: Appellate Mechanism and Enforcement Issues' UNCITRAL WG III 40th Session UN Doc A/CN.9/WG.III/WP.202 (2020).
[31] Schill (n 2).

produced by international organisations. Specific maters are explicitly excluded from ISDS clauses and are to be resolved solely by states or prior to the issue being brought before ISDS.

These "carve-outs" narrow the scope of ISDS and provide the states additional control over specified matters or areas of policy for political and/or legalised dispute settlement by national authorities and/or treaty organisations. States have done this for highly complex or sensitive circumstances, including financial services, tax policies, ad hoc problems like tobacco control, and a broad range of "public welfare" initiatives.[32] Such provisions significantly narrow the scope of an investor's rights as the requirement is normally coupled with a short period for filing claims.[33] However, these provisions are only effective for States that can confidently attract foreign investment since investors are unlikely to be willing to invest in countries having constrained and restrictive investor protection regimes.

v. *Multilateral Investment Treaty*

Some States have proposed the notion that a "menu" of ISDS reform choices is the best course of action. They proposed that states should have the flexibility to adopt a reform of their choosing.[34] This is similar to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting of the Organisation for Economic Co-operation and Development.[35] Such a multilateral treaty would have multiple methods of dispute settlement, and would allow States to select which of their current IIAs would be covered by the new treaty's numerous dispute resolution mechanisms. Certain investor rights would be adaptable to whichever venue each of them deems to be the best for enforcement and interpretation.

States could maintain as many different investment laws as they want, and could combine those substantive restrictions with the enforcement method that best suits their needs. This greatly expands the choices available to states and is a significant improvement over the more binary options now available to states — for example, between ISDS and a national tribunal or between ISDS and the Multilateral Investment Court. The multilateral agreement option appears to be an ideal and flexible response for states that must choose between "imperfect alternatives" because of their different demands.[36]

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[32] China-Australia Free Trade Agreement (17 June 2015), arts 9.11(4)-(8), 9.19; Australia-Hong Kong Investment Agreement (26 March 2019), art. 13(5).

[33] Agreement between the United States of America, the United Mexican States, and Canada (30 November 2018), art 3.

[34] UNGA 'Possible Reform of Investor–State Dispute Settlement: Submission from the Governments of Chile, Israel and Japan' UNCITRAL WG III 37th Session UN Doc A/CN.9/WG.III/WP.163, 3 (2019).

[35] UNGA 'Possible Reform of Investor–State Dispute Settlement: Submission from the Government of Colombia' UNCITRAL WG III 38th Session UN Doc A/CN.9/WG.III/WP.173, para 19 (2019).

[36] Sergio Puig and Gregory Shaffer, 'Imperfect Alternatives: Institutional Choice and the Reform of Investment Law' (2018) 112 AJIL 361.

Conclusion

The ongoing critique of the ISDS system highlights the need for a comprehensive reform to address concerns over transparency, fairness, efficiency, and public interests. The proposed alternatives discussed above reflect a concerted effort to achieve a balance between protecting foreign investments and upholding states' regulatory autonomy. Reforming the ISDS system through the suggested alternatives reflects a necessary evolution towards a more balanced and sustainable investment framework. The alternatives discussed in this paper offer valuable pathways to address the shortcomings of ISDS system.

However, no single alternative is without its drawbacks. It may be effective to adopt a hybrid approach by incorporating different elements of the discussed alternatives to create a system that not only protects investments but also prioritises sustainability and human rights. A framework such as this would retain the procedural strengths of ISDS – neutrality and accessibility, while ensuring transparency and the state's regulatory autonomy. This balance is vital to foster an investment climate that is both legally robust and socially responsible, thus enabling sustainable growth and equitable dispute resolution.