International investment but at what cost?

Investor-State dispute settlement and developing countries

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The inclusion of investor-State dispute settlement (ISDS) provisions in international investment agreements may end up undermining public welfare, particularly in developing countries. From ‘regulatory chill’ to huge legal fees, ISDS shrinks the regulatory space of developing countries unless negotiators consider a range of options.

This short piece presents the good, the bad and alternatives to the traditional ISDS model.

Foreign investors protect their business interests and manage risks through provisions included in bilateral investment treaties (BITs) or treaties with investment provisions (TIPs). One such mechanism is investor-State dispute settlement (ISDS).

What otherwise would be a State-State engagement, a conventional ISDS model allows a transnational corporation bring claims against a host State before arbitration tribunals for conciliation or arbitration. Legal disputes are often submitted to the International Centre for Settlement of Investment Disputes (ICSID) under the ICSID Convention; or the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

While investor’s home State is not party to the dispute, it negotiates such provisions in investment treaties to protect domestic companies investing abroad. ISDS safeguards investors from new domestic policies and regulations in breach of standard of treatment and protection including national treatment, most-favoured nation treatment, fair and equitable treatment, full protection and security, and compensation for lawful expropriation, among others.

Developing countries and ISDS: what the data tell us about the last ten years
Between 2010 and 2019, developed country investors brought majority of the ISDS cases against developing and transition economies. According to data from UNCTAD, in the last ten years, of the total 653 ISDS cases, 453 (69%) were against developing countries, including least developed countries (LDCs), and transition economies. Of these, investors from developed countries brought more than two-thirds (311) of the cases.

Only half of the claims against developing countries, including LDCs, and transition economies were concluded by end of 2019. Of the 154 concluded cases, 37% of these were decided in favour of State and 30% in favour of investor. However, as we will see in the next section, winning an ISDS litigation is a Pyrrhic victory that comes with high cost. During the ten-year period, the rest of the concluded cases were settled (19%), discontinued (12%) and in three of the cases, ICSID made a ruling in favour of neither party – that is, while the tribunals found liability, no damages were awarded (Figure 1).

*Figure 1 Outcome of concluded arbitration proceedings: investors from developed countries v. respondent developing countries, incl. LDCs, and transition economies, 2010-2019*

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Percentage</th>
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<tr>
<td>In favour of State</td>
<td>37%</td>
</tr>
<tr>
<td>In favour of investor</td>
<td>30%</td>
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<tr>
<td>Settled</td>
<td>19%</td>
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<tr>
<td>Discontinued</td>
<td>12%</td>
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<tr>
<td>Neither party</td>
<td>2%</td>
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*Source: Autor’s own based on UNCTAD, ISDS Navigator*

Venezuela, Egypt, Peru, Mexico and Colombia were the most sued developing countries in the last ten years; while two-thirds of the 311 cases against the lower income countries were filed by investors from 5 developed countries, with USA taking the lead (Figure 2).
In the ten years between 2010 and 2019, about 95% of claims against developing countries, including LDCs, and transition economies were brought before ICSID (61%)\(^1\) and UNCITRAL (34%). The rest were submitted to rules of the Stockholm Chamber of Commerce and International Chamber of Commerce.

**Pros of including ISDS in international investment agreements**

At first glance, including ISDS provisions in BITs or TIPs seem to result in a win-win for everyone. Developing countries potentially stand to attract international investments while foreign investors ensure their interests are protected and risks managed reasonably. In other words, ISDS provisions signal *better investment climate* by offering protection against domestic regulatory systems that infringe returns or discriminate in favour of national investors.

ISDS allows to avoid *diplomatic tensions* between the home and host governments. It can be argued that a regulation on the part of a state that does not impact directly the national economy or an industry of the home State, but only the investor’s operations, are best left for the investor as a claimant.

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\(^1\) This figure includes 7% of the cases submitted to ICSID’s Additional Facility (ICSID AF) in the ten years’ period under review
ISDS provisions do not prevent governments from regulating in the public interest. Treaties grant flexibilities to safeguard public welfare, protect public health and the environment. Neither do they prevent governments from changing their domestic policies. However, as we will see below, governments may restrain themselves from adopting policies intended for public welfare, or what is commonly referred to as regulatory chill\(^2\), as a result of the threat of arbitration.

**Cons of including ISDS in international investment agreements**

Understandably, investors prefer stronger protection, particularly in countries with weaker legal systems. The conventional ISDS mechanism, however, grants excessive rights to foreign investors at the cost of eroded national sovereignty, undermined public welfare and exorbitant claims and legal costs.

ISDS involves high unrecoverable legal costs. It is possible for developing country members to lose as a result of being outlawyered\(^3\) rather than on the substantive merits. OECD survey (2012) finds ISDS costs on average US$8 million per case and can exceed US$30 million per case. In the Philip Morris v. Australia case, Australia’s claim over legal and arbitration costs were reported to be as high as AU$50 million (US$ 38 million). The legal costs are more taxing when the respondent is a developing country. For instance, in the Pac Rim v. El Salvador case that lasted seven years and despite the case ending in favour of the State, the latter had to spend over US$12 million on defence.

ISDS damage claims could be staggeringly high. In 2014, a lawsuit brought before the ICSID had a claim for US$1,315 million in the Churchill Mining and Planet Mining Plc v. Indonesia case. This is equivalent to building 731 hospitals in the country.\(^4\)

Providing legal certainty at all levels of government might be difficult in certain circumstances. In the Metalclad Corporation v. Mexico case, the federal permit was contradicted by Mexican local governments of San Luis Potosí and Guadalcázar to operate a hazardous waste disposal facility. In addition, the local government issued an Ecological Decree that precluded the use of the facility. The tribunal found Mexico in breach of indirect expropriation, fair and equitable treatment/minimum standard of treatment, and

\(^2\) States refrain from regulating in the public interest in a timely and effective manner due to ISDS concerns (Tienhaara, 2010).

\(^3\) OECD (2012)

\(^4\) Estimation taken from a hospital cost in Rakhine State, Indonesia (at US$1.8 million)
full protection and security; and awarded the investor US$16.70 million as compensation for barred operation of the facility.

Legal costs and claim amounts likely result in regulatory chill thereby eroding national sovereignty. While ISDS provisions do not prevent countries from changing policies and regulations, they could undermine regulations pursued in the public interest such as labour, food safety, public health or environmental standards. In Vattenfall v. Germany (I), the Swedish energy group submitted compensation claim against the Hamburg government authorities’ permit that restricts water use and cooling water discharge. The ICSID tribunal was advised by the Parties on the discontinuance of the proceedings but only after the respondent changed the water use permit to a much lower environmental standards5. Other examples on undermined public welfare are the Novartis-Colombia (threat to file) and Gilead-Ukraine (withdrawn) cases, where the respondent States reversed intentions to issue compulsory licence and register a state agency for generic anti-viral drugs, respectively.

COVID-19 pandemic heightens, more than ever, the concern over ISDS in undermining protection of public health. As noted by the International Institute for Sustainable Development (Bernasconi-Osterwalder et al., 2020), containment measures affect adversely business interests of transnational corporations. Governments’ actions to close non-essential services as well as borders and airspace, temporary nationalisation of private hospitals, and export bans on medical supplies, medicines and even food could result in a series of litigation. What is likely to be a nightmare to many countries, these may force governments in the near future to spend millions of dollars on defending their actions.

Alternatives to the traditional ISDS model

Increasingly, investor-State arbitrations have come under scrutiny and newly concluded BITs and TIPs have started reflecting reform elements. According to UNCTAD (2020a), in 2019 alone, of the total 22 concluded international investment agreements, 15 of them had ISDS reform-oriented provisions; whereas three of the treaties omitted ISDS.

In the absence of irrefutable evidence that international investment treaties with ISDS mechanism improve high quality international investment flows6, economic partnership

5 See Verheyen’ 2014 Briefing Note.
6 High quality foreign investment may include technology and knowledge transfer, the number of decent jobs created, improved international market access and business competitiveness of the economy, responsible tax
negotiators should continue to explore options that do not shrink the policy space. For investment treaties that have already included ISDS, parties can work towards a reform on withdrawal of consent to arbitration and/or termination. In fact, according to UNCTAD (2020b) the number of international investment agreements terminations exceeded the number of new agreements in 2019. This is even easier when treaties include clauses for termination at any time after entry into force.

The main argument of this paper is the principal objective of investment treaties should not be limited to protection of investments. Neither should the role of governments be relegated to only creating and maintaining an enabling investment environment at the expense of the national interest. To shift the exclusive power that transnational corporations hold, either exclude ISDS in BITs and TIPs or curb the corporations’ excessive rights (Figure 3).

Figure 3 Towards better investment dispute settlement systems

One option is to omit ISDS from treaties or opt out of ISDS provisions. As mentioned above, three treaties concluded in 2019 omitted ISDS. In the ongoing Regional Comprehensive Economic Partnership that will comprise an investment chapter, reports indicate countries agreed to address ISDS provisions in the future instead of including them now (UNCTAD, 2020b). Members can also opt out of ISDS provisions. One notable recent example is Canada’s decision not to be part of ISDS in the United States-Mexico-Canada Agreement (USMCA).

practices such as compliance with tax legislation and payment of the right amount of tax, large portion of proceeds remaining in the economy and commitment to advance labour and environmental standards.
In the absence of an ISDS mechanism, one recourse is considering *domestic courts as the only option to adjudicate disputes*. This also allows local communities affected directly by foreign investments to access and be enjoined in the legal proceedings. In countries with weak legal systems and loose application of rule of law, investment agreements need to provide for capacity building in order to strengthen domestic legal systems at national and sub-national levels.

If investment treaties omit ISDS, another option for investment dispute settlement is to consider *State-State arbitration* instead of international tribunals. One such example is Brazil’s model of Cooperation and Investment Facilitation Agreements (CIFA). *Brazil* has been pursuing CIFA since 2015, which is not solely vested in investor protection but rather promotion of cooperation and investment between bilateral investment Parties.

If treaties must provide for ISDS, it is possible to minimise the costly nature of such provisions by narrowing their application and access to international arbitration. Exhausting local dispute remedies first before submitting claims for international arbitration is one way of narrowing the application of ISDS. It is noted that even in advanced legal systems, international investment agreements ‘remove the duty to exhaust local remedies’ (Kaufmann-Kohler & Potestà, 2020). This reform element is reflected in USMCA, whereas unless ‘the recourse to domestic remedies was obviously futile’ (footnote 25 of Chapter, 14-D-5), the Agreement limits claims submitted to arbitration unless the claimant first brings claims to domestic courts.

Negotiating countries can also *narrow the application of ISDS* in investment agreements by limiting the investors’ claims. For instance, under Article 14.D.3 of ‘Submission of a Claim to Arbitration’ of USMCA, the claimant, on its own behalf, may submit application for arbitration in the case of breaches of, and loss or damage thereof, national treatment or most favoured nation or expropriation and compensation. However, the Article does not grant the claimant the right to seek arbitration in the case of indirect expropriation; and the establishment or acquisition of an investment.

**Conclusion**

ISDS does not work in the interest of developing and transition economies. The legal proceedings are often protracted, expensive and potentially discouraging to regulators from pursuing regulations in the public interest in a timely manner. In the spirit of cooperation and mutual benefits, treaty negotiators should consider a model that takes investment dispute
resolution from a Pyrrhic to an Irenic victory. Ultimately, the traditional ISDS mechanism that grants excessive rights to trans-national corporations need to be replaced by stronger domestic legal recourse, complemented by a State-State arbitration mechanism.

References


