

trade hottopics

Policy Linkages of Investor-State Dispute Settlement

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Background

The inclusion in International Investment Agreements (IIAs) of investor-state dispute settlement provisions is a significant innovation in international law-making. The provision provides investors of a state that is a party to an IIA the right to initiate binding arbitration against the other party state in order to claim compensation for the other party state's non-compliance with the substantive standards of protection set out in the agreement.

For investors, this provision allows them to directly initiate claims against another party state—thereby negating the difficulties faced in lobbying its home state to pursue these within the rubrics of traditional state-state dispute settlement procedures. States, on the other hand, have good reasons to avoid international investor-state arbitration in their investment treaties and contracts. These include the high costs to defend claims,¹ conflicting interpretations by tribunals, a rising number of arbitrations (including against small and least developed states²), and ambiguous evidence on the expected benefits of investor-state arbitration to host countries. However, for diverse reasons, a state may choose to consent to investor-state arbitration. In such cases, further issues arise about the form of the state's consent.

This issue of *Commonwealth Trade Hot Topics* offers a preliminary insight into what it means for developing country governments to commit to investor-state dispute settlement, and how this commitment entails linkages to their development policy space and regulatory decisions.

Setting the context

The context within which these issues can be discussed varies depending on a state's existing treaty obligations and whether potential consents to investor-state arbitration are contained in a contract, bilateral investment treaty (BIT), or free trade agreement (FTA) that combines trade and investment provisions. While contracts probably present the most pressing concerns for small developing countries, regional trade agreements (RTAs) are also an expanding and significant forum for investment liberalisation, with particular concern in this regard focused on the interaction

¹ Countries typically face legal and arbitration costs in the millions (sometimes, tens of millions) of dollars in investment arbitrations.

² At least 27 arbitrations have been initiated against small or least developed states since 2000, including against Bangladesh, Burundi, Democratic Republic of Congo, Dominican Republic, Estonia, Gabon, The Gambia, Grenada, Guinea, Guyana, Myanmar, Seychelles, Trinidad and Tobago, United Republic of Tanzania, and Yemen. In 2007, Nigeria and South Africa faced arbitration proceedings for the first time.

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between the investment and services chapters. Other important contextual considerations include the manner in which a state, negotiating these agreements, construes its interest as a capital-exporter, capital-importer, or both.

In the case of Commonwealth members, of the 38 countries for which data was available,³ all but three (Botswana, Canada, and the United Kingdom) were capital-importers.⁴ For the 35 capital-importing countries, the ratio of inward to outward foreign direct investment (FDI) stock was on average 79 to 1 (with a medium of 6 to 1). Most Commonwealth countries are thus capital-importers; in some cases, overwhelmingly so.⁵ Where this means that a BIT or RTA, in its effects, is one-sided — in that the FDI flows are mostly one-way — this will heighten the potential costs and risks for the capital-importing Commonwealth country.

Committing to investor-state dispute settlement

For diverse reasons, a state may choose to avoid or consent to investor-state dispute settlement. In the latter case, a critical starting point for governments would be in the formulation of an overall national policy to guide its consideration on whether, and if so how, to consent to investor-state arbitration. In developing the policy, a critical issue at the outset is the appropriate arbitration forum and rules. Other considerations in this regard include an understanding of the nature of investment treaties and investor rights given the dual role of states as treaty parties and respondents; the interpretive balance of power created between treaty parties and tribunals charged with resolving investor-state disputes; and how treaty parties and investment tribunals are likely to interact strategically. Choices at this stage will have profound implications where a state is required to defend against claims or pay large awards.

These choices thus shape the risks that a government will need to redirect limited funds to litigation or pull back from development policies in the face of a claim. All of these issues are cross-cutting for investment contracts, BITs and FTAs.

Who holds ultimate power in an arbitration?

Besides the arbitrators themselves, who holds the power behind the scenes in investor-state arbitration is important. Unless this question is resolved by the contract or treaty itself, then the ultimate appointing authority in an arbitration will be dictated by the rules under which a state gives its consent to

arbitration in the contract or treaty (see Appendix). Each of these arbitration institutions offers its own unique legal and political environment.

The fundamental question is who will have the final say over a government's decisions. By consenting to investor-state arbitration, a state subsumes its government within the most powerful system of international adjudicative discipline since the colonial era and since unequal treaties. The choice of appointing authority determines who has the ultimate power to appoint arbitrators, where an award may be reviewed, the level of secrecy in the process, and the state's degree of control over the arbitration rules.

Investor-state arbitration subjects a state to the authority of arbitrators and appointing authorities, but also to the extraterritorial authority of other countries. When an award is made against a country, powers to review the award — in order to determine whether the arbitrators interpreted the contract, treaty, or a state's own laws appropriately — are assigned to the courts of other countries. Just which court will have this power depends on complex choice-of-jurisdiction rules in the arbitration rules and on the terms of the New York Convention or ICSID Convention, whichever is applicable, as they deal with the recognition and enforcement of awards.

Fundamentally, investor-state arbitration establishes international and extraterritorial authority in ways that other treaties do not. It allows claims against sovereign states by individual investors, without requiring the investor to seek relief in domestic courts or tribunals. It also allows money damages to be awarded against the state and for those awards to be enforced against assets of the state held abroad.

What are the preferred arbitration rules and forums?

Because of this power of investor-state dispute settlement, any government — if it decides to consent to this review mechanism — should develop

³ Based on a comparison of UNCTAD World Investment Report data on inward FDI stock to outward FDI stock for 2004. Those states whose inward FDI stock exceeded their outward FDI stock were treated as capital-importers, and vice versa.

⁴ The 35 capital-importers for whom data was available were Australia, The Bahamas, Bangladesh, Barbados, Belize, Brunei Darussalam, Cameroon, Cyprus, Fiji Islands, The Gambia, Ghana, Guyana, India, Jamaica, Kenya, Lesotho, Malawi, Malaysia, Malta, Mauritius, Mozambique, Namibia, New Zealand, Nigeria, Pakistan, Papua New Guinea, Rwanda, Seychelles, Singapore, Sri Lanka, South Africa, Swaziland, Trinidad and Tobago, Uganda, and Vanuatu.

⁵ This reflects an overall FDI stock position which may vary significantly in the case of specific bilateral relationships.

a policy on its preferred appointing authority. In this respect, two broad assumptions will be made here. The first is that states should choose an appointing authority that is neutral and politically balanced, and that is accountable to states. The second is that states should choose an appointing authority that is reasonably insulated from the private industry or ‘club’ of international arbitrators. Based on these assumptions, here are a few recommendations:

- (1) States should limit the choice of arbitration rules given to potential claimants. Doing so allows a state to focus on the right forum at the time that a contract or treaty is negotiated, to monitor usage of the rules, and to focus on appropriate reforms in that forum.
- (2) Among the commonly-used rules (see Appendix), the ICSID Rules and the ICSID Additional Facility Rules are probably the best of a limited set of possibilities. These rules designate an appointing authority that is accountable to states and whose performance can be tracked based on public information. On the same criteria, the next-best choice is the UNCITRAL Rules, whereas the ICC and SCC Rules should be avoided.
- (3) When choosing arbitration rules, states should evaluate the ‘politics’ of the appointing authority. The International Centre for Settlement of Investment Disputes (ICSID) exists mainly in a US orbit; the Permanent Court of Arbitration (PCA) in a Western European (especially Dutch) orbit; and the International Chamber of Commerce (ICC) and Stockholm Chamber of Commerce (SCC) in the orbit of their business constituencies.
- (4) Because of the ICC’s close connections to investor interests and to the arbitration industry, and the inability to scrutinise the decisions of ICC arbitrators for possible patterns of unfairness or conflicts of interest, states may wish to consider withdrawing references to the ICC Rules from their contracts and treaties.
- (5) States should consider developing alternative forums for investor-state adjudication, perhaps at the regional level.
- (6) Governments should develop an in-house team that can provide trusted and independent legal advice to senior decision-makers on investment contracts, treaties, arbitration rules, and arbitrations.

What is the legal and political environment of different forums?

The fundamental question beneath these recommendations is: who should a state trust as an appointing authority? How neutral will that authority be, and who wields influence within it?

Under the ICSID Rules and the ICSID Additional Facility Rules, appointing authority rests with the President of the World Bank, informed by ICSID staff. Many treaties designate instead the ICSID Secretary-General as the appointing authority. Customarily, the World Bank President is an appointee, effectively, of the US Administration. This indicates how the USA, and other countries that wield major power at the World Bank, may prefer ICSID specifically because of the power relations within the World Bank.

Recently there were explosive comments by an arbitrator, Jan Hendrik Dalhuisen, in a recent award about alleged interference by ICSID staff in the decision-making process of an ICSID panel and about unhealthy practices of arbitrators in seeking reappointments.⁶ This may ring alarm bells for policy-makers and treaty negotiators. It conveys how the choice of appointing authority may carry important policy linkages for developing states. However, we know about this concern at ICSID only because ICSID typically allows its awards to be published. In contrast, we know very little about ICC arbitration, for example, because of the comparative secrecy of its process. This makes it impossible for states to verify the independence and impartiality of the ICC process.

The ICC Rules are administered by the International Chamber of Commerce in Paris. Unlike ICSID or the PCA, the ICC is a business organisation that is accountable to its private members. The ICC advocates for investors and promotes investor-state arbitration while also delivering arbitration services. It was identified in a 1997 study by Dezalay and Garth as ‘one of the principal places where the “politics” of arbitration is elaborated and expressed’.⁷ Due to the relative secrecy of ICC arbitrations, it is impossible to verify (but likely) that many investors who bring claims under the ICC Rules are themselves members of the ICC or an ICC affiliate. This raises important considerations about

⁶ *Compania de Aguas del Aconguija & Vivendi v. Argentina Republic*, ICSID Case No. ARB/97/3, Annulment Award (20 August 2007), Additional Opinion of Professor Jan Hendrik Dalhuisen.

⁷ Y Dezalay and B Garth, *Dealing in Virtue* (University of Chicago Press, 1996).

the independence and impartiality of the arbitration process.

The membership of the ICC International ‘Court’ of Arbitration includes practising lawyers and arbitrators who are participants in the arbitration industry. In 2008, the chair of the ICC Court, Pierre Tercier, resigned, reportedly because of objections that the body was not sufficiently independent of the ICC Secretariat.⁸ Again, this may ring alarm bells.

Under the UNCITRAL Rules, the Permanent Court of Arbitration appoints the appointing authority where necessary in an arbitration. Historically, the Dutch Government has occupied a prominent role at the PCA. In the past, the PCA has chosen the International Chamber of Commerce, the Stockholm Chamber of Commerce and particular persons as the appointing authority. It appears unfortunate that the PCA, a public body, would hand over appointing authority to a private arbitration institution.

The SCC Rules are associated with the Stockholm Chamber of Commerce and administered through the SCC Arbitration Institute. The origins of the SCC Rules lie in the arbitration of East–West trade disputes during the Soviet era. The SCC Institute has reported that it administered hundreds of arbitrations during 2001–2009, including 30 treaty arbitrations. The Board of the SCC Institute is dominated by practising lawyers and arbitrators. Like the ICC, the SCC is a business organisation, accountable to its private membership rather than to states.

The role of the arbitration ‘club’

In scholarly research on international arbitration, those who work as commercial arbitrators have been described as a ‘club’ or ‘industry’ based in major arbitration centres like Paris, London, and Washington. The club, it is said, has ‘gatekeepers’ who recommend each other, or aspiring members, for appointments. Arbitrators may also earn significant income from legal practice in investment law, while deciding the law and the specific cases. This raises possible conflicts of interest and may undermine confidence in the independence of the arbitration process.

An important issue in the choice of appointing authority, then, is the degree to which an authority is insulated from the club. Among the staff of appointing authorities, there is often movement in and out of the arbitration industry. It is obviously of interest to law firms and prospective arbitrators to

have contacts in the appointing authorities, but the movement in question may create impressions that the industry’s interests are driving arbitrations or policy decisions. For a state, it will be important to evaluate industry connections when choosing arbitrators and legal advisers and when assessing advice that is provided.

Conclusions

The development policy linkages of investor-state arbitration make it desirable to use arbitration forums that are accountable to states, rather than the private interests of investors or the lawyers of the arbitration club. Publicly accountable forums do not raise as many concerns about potential impartiality, in part because their decision-making is more open to public scrutiny. This points to a preference for the ICSID or the ICSID Additional Facility in investor-state dispute settlement, followed by the UNCITRAL Rules. On the same basis, the ICC and SCC Rules should be avoided.

As the use of investor-state dispute settlement spreads and intensifies in contracts, BITs, and FTAs, states should also consider new forums for arbitration. All of the arbitration rules commonly in use have important limitations, such as potential conflicts of interest, that warrant careful attention. A key aim — with important linkages to development policy — is to design a dispute settlement process that considers fairly the priorities and interests of developing states, including smaller states.

⁸ N Goswami, ‘ICC left reeling as arbitration court chairman Tercier resigns’ *The Lawyer* (31 March 2008).

Appendix: Outline of common arbitration rules

The five sets of rules that are commonly used in investment arbitration are the following:⁹

- *ICSID Rules*. Administered by the International Centre for Settlement of Investment Disputes in Washington DC, an arm of the World Bank. Used in 54 per cent of 228 (confirmed) investment treaty cases.
- *UNCITRAL Rules*. Adopted by the UN Commission on International Trade Law as commercial arbitration rules in 1976. Administered by the Permanent Court of Arbitration in The Hague. Used in 30 per cent of confirmed treaty cases.
- *ICC Rules*. Established by the International Chamber of Commerce in Paris and administered by its International ‘Court’ of Arbitration. Used in 1 per cent of confirmed treaty cases and widely under investment contracts. The ICC reports, during 2005—2009, an average of 69 arbitrations per year involving a state or state entity.
- *ICSID Additional Facility Rules*. Available as an alternative to the ICSID Rules where a claim falls outside of ICSID jurisdiction because the host state or the home state is not a party to the ICSID Convention. Used in 10 per cent of confirmed treaty cases, mostly under the North American Free Trade Agreement (NAFTA).
- *Stockholm Chamber of Commerce Rules*. Administered by the SCC Arbitration Institute. Developed historically to resolve East—West trade disputes. Used in 5 per cent of confirmed treaty cases. Some SCC awards, especially under the Energy Charter Treaty, have become public.

Most investment treaties allow investors to bring claims under several of these rules, whereas investment contracts often provide a choice of only one set of rules.

⁹ Confidentiality requirements in the UNCITRAL, ICC, and SCC Rules mean that confirmed data significantly under-estimates their role in investment arbitration. Further, data on contract arbitrations under the UNCITRAL, ICC, and SCC Rules is difficult to collect reliably. The data noted in this paper was collected from publicly-available information on known investment arbitrations up to 1 June 2010.

International Trade & Regional Co-operation Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth — an association of 54 independent states, comprising large and small, developed and developing, landlocked and island economies — facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies — least developed countries (LDCs) and small states.

Scope of ITRC Work

ITRC undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research and consultations increase understanding of the changing of the international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

ITRC Recent Activities

ITRC's most recent activities focus on assisting member states in the WTO Doha Round and the Economic Partnership Agreement (EPA) negotiations involving the African, Caribbean and Pacific countries (ACP) the European Union (EU), undertaking analytical research on a range of trade policy and development issues, and supporting workshops/dialogues for facilitating consensus-building on issues of Commonwealth members' interest, exchange of ideas, and disseminating results from informed analysis.

Selected Recent Meetings/Workshops supported by ITRC

9 March 2011: Consultative Meeting on Trade Effects of Rules on Procurement for Commonwealth ACP members held in London, UK.

8 March 2011: Consultative Meeting on Making Trade in Services Supportive of Development in Commonwealth Small and Low-Income countries, held in London, UK.

16-18 February 2011: Conference on Regional Integration titled 'Caribbean Community and the Commonwealth: Collective Responsibility in the Twenty First-Century', held in Kingston, Jamaica.

17-19 December 2010: 3rd South Asian Economic Summit titled, Regional Economic Integration, Climate Change and Food Security Agenda for the Decade 2011-2020, held in Kathmandu, Nepal.

25-26 November 2010: Regional Seminar on Trade Policy for Commonwealth Caribbean Parliamentarians, held in St. Kitts & Nevis.

24-26 November 2010: International Dialogue titled, Exploring a New Global Partnership for the LDCs in the Context of the UN LDC IV, held in Dhaka, Bangladesh.

15-17 November 2010: Workshop on Competitiveness Strategies with Special Reference to African and Indian Ocean Small States, held in Port Louis, Mauritius.

3 November 2010: Pre-LDC IV African Civil Society Forum, held in Arusha, Tanzania.

16 September 2010: WTO Public Forum Session on Africa in international trade: impediments and opportunities, in Geneva, Switzerland.

28 June 2010: Consultation Meeting on WTO Accession, held in Brussels, Belgium

26 June 2010: Workshop on Policy Barriers in Intraregional Trade in South Asia, held in Dhaka, Bangladesh

Selected ITRC Publications

Collier, P. (2011). *Catching Up: What LDCs Can Do, and How Others Can Help*, London: Commonwealth Secretariat.

Cali, M., Razzaque, M. A. and Te Velde, D. W. (2011). *Effectiveness of Aid for Trade in Small and Vulnerable Economies*, Economic Paper No. 91, London: Commonwealth Secretariat.

Cali, M with Kennan, J (2010). *The Global Financial Crisis and Trade Prospects in Small States*, Economic Paper, London: Commonwealth Secretariat.

Milner, C., Morrissey, O. and Zgovu, E. (2010). *Policy Responses to Trade Preference Erosion: Options for Developing Countries*. London: Commonwealth Secretariat.

Jones, E., Deere-Birkbeck, C. and Woods, N. (2009). *Maneuvering at the Margins: Constraints Faced by Small States in International Trade Negotiations*. London: Commonwealth Secretariat.

Razzaque, M. A. (ed) (2009). *Trade, Migration and Labour Mobility*. London: Cameron May.

Srinivasan, T N (2009). *LDCs, Landlocked Developing Countries and Small States in the Global Economic System*. London: Commonwealth Secretariat.

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Winters, L A et al. (2009). *An EU-India Free Trade Agreement: Reflections on the Implications for Excluded Countries*. London: Commonwealth Secretariat.

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Grynberg, Roman and Newton, Samantha (eds) (2008). *Commodity Prices and Development*. Oxford University Press.

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