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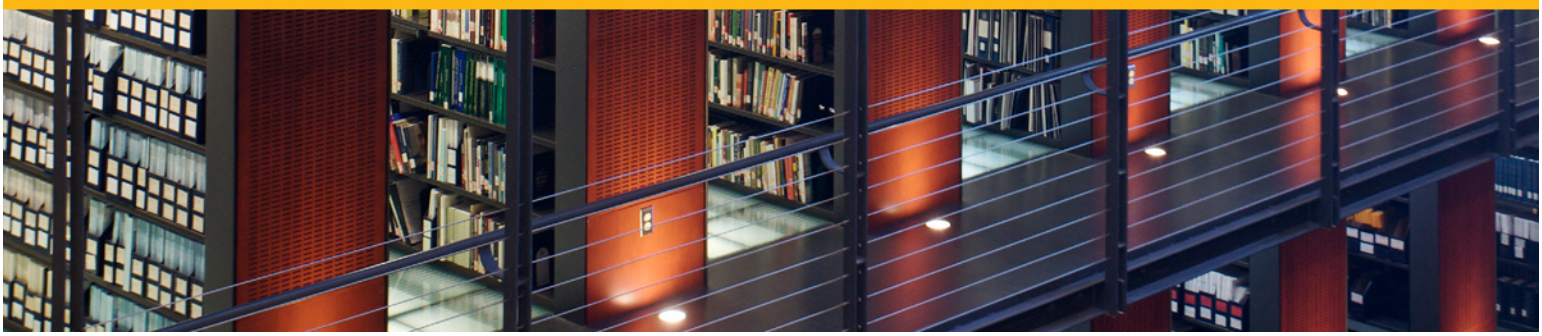

Investor–State Dispute Settlement Mechanisms: What Is Their History and Where Are They Going?

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Alexandre Gauthier

Economics, Resources and International Affairs Division
Parliamentary Information and Research Service

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INVESTOR–STATE DISPUTE SETTLEMENT MECHANISMS: WHAT IS THEIR HISTORY AND WHERE ARE THEY GOING?

1 INTRODUCTION

In 1959, Germany and Pakistan reached a trade agreement to encourage and protect investments between the two countries. The agreement included the first-ever investor–state dispute settlement (ISDS) mechanism. Since then, thousands of agreements containing a similar provision have been reached around the world. Canada is no exception – many of its current agreements provide for this type of mechanism.

An ISDS mechanism is a legal provision in bilateral or multilateral investment agreements or in the chapters on investment protection in free trade agreements (FTAs). It gives investors the right to international arbitration if they believe a foreign government that is party to the agreement has breached one of its provisions.

Investment agreements are often reached between developed countries and developing countries, or countries with legal systems that do not offer the same guarantees of independence, effectiveness and transparency as those of their investment partners. ISDS provisions are included primarily to send a signal to investors in developed countries that their money will be protected from misuse by local governments, through such actions as expropriation without proper compensation, for example. By offering this protection, developing countries hope to increase investment flows into their economies.

ISDS mechanisms have been operating quietly for some time. This situation has changed in recent years, primarily because of a few high-profile legal cases and the reluctance of some European stakeholders to include an ISDS mechanism in the comprehensive economic and trade agreement (CETA) between Canada and the European Union (EU)[1] or in a future transatlantic trade and investment partnership between the United States and the EU. Criticism of the ISDS system has grown to such an extent that the United Nations Conference on Trade and Development (UNCTAD) included a series of proposals for reforming ISDS mechanisms in its *World Investment Report 2015*, noting that maintaining the status quo is not a viable option.[2]

2 PURPOSE AND STRUCTURE

As mentioned earlier, the main purpose of ISDS mechanisms, like the international investment agreements that provide for them, is to protect foreign investors and thereby encourage increased investment flows between the signatory countries.

If there is no ISDS mechanism, foreign investors can turn to the domestic courts of the countries in which they have invested. However, that means of recourse presents a problem on two levels.

First, domestic courts differ from one country to the next. Investors could be concerned that the court system lacks the guarantees of transparency and effectiveness to which they are accustomed in their home countries. Second, some claim that domestic courts may not be fully independent and may be biased against foreign investors, particularly since the respondent party is the government of the country where the courts are based.

The purpose behind introducing ISDS mechanisms is to establish an impartial dispute resolution mechanism based on international standards. Generally speaking, settlement procedures to settle disputes between an investor and a state in ISDS cases are conducted in compliance with the *Convention on the Settlement of Investment Disputes between States and Nationals of Other States* (ICSID Convention),[3] the Additional Facility Rules of ICSID or the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

Access to an ISDS mechanism is especially useful for small investors who lack the resources to understand the subtleties of foreign legal systems, which often function in a foreign language. Moreover, having an ISDS mechanism means that investors do not need to ask their own government for help through state-to-state dispute resolution.

ISDS arbitration tribunals do not have the power to overturn national laws or regulations, or to order a party to pay punitive damages. However, tribunals can order a party to compensate an investor who incurred loss or damage because the party breached its obligations.

If a state fails to enforce the final award of an arbitration tribunal, investors have several options, including seeking diplomatic protection from their home state, or trying to reach a settlement with the state in question to avoid an enforcement procedure. Most likely, however, investors will turn to a court in the state in question to enforce the award.[4]

3 CURRENT SITUATION

Annual data from UNCTAD show that investment agreements continue to be a popular tool internationally. In 2014 alone, 27 new agreements were concluded, bringing the total number to 3,268.[5]

3.1 CANADA

Canada pursues investment agreements fairly actively through foreign investment promotion and protection agreements (FIPAs) or investment chapters in FTAs. An ISDS mechanism is a key element of these agreements. In fact, the 29 FIPAs and 7 of the 11 FTAs[6] that are in force in Canada include this mechanism.[7]

To date, Canada has received 37 notices from investors of their intent to submit a claim to ISDS arbitration.[8] All notices were delivered pursuant to Chapter 11 of the *North American Free Trade Agreement* (NAFTA).[9]

- Of these, 23 cases went to arbitration,[10] and the Government of Canada was required to pay damages in two of them: $6 million plus costs to S.D. Myers Inc. in 2000,[11] and $460,000 plus costs to Pope & Talbot Inc. in 2012.[12]
- A tribunal established under Chapter 11 of the NAFTA also decided in favour of two other investors, but has not yet set the amount of damages payable by the Government of Canada.[13]
- The Government of Canada also settled three cases before a NAFTA Chapter 11 tribunal could make a determination. In all three, either the Government of Canada or a provincial government paid the claimant;[14] for example, AbitibiBowater Inc. received $130 million in a settlement in 2010.

While these awards are considerable, it is worth noting that foreign investment stock in Canada reached $732 billion in 2014. That same year, stock invested in Canada from the U.S. – the country of origin of all investors that have filed a complaint against Canada to date – totalled $350 billion.

3.2 THE INTERNATIONAL STAGE

Internationally, 42 new ISDS cases were initiated in 2014, bringing the total to 608 known cases to date.[15] The 2014 figure is below the record 59 cases launched in 2013, but far above the number of cases in the 1990s, when the number ranged from 0 to 10 annually.[16]

While there may be a number of reasons for this increase, the key factor appears to be that foreign direct investment (FDI) has also increased considerably in recent decades. In fact, the world's inward FDI stock, which totalled $2.2 trillion in 1990, reached $26 trillion in 2014.[17] There is a significant correlation between the increase in foreign investment and the number of ISDS cases.[18]

In 2014, ISDS arbitration tribunals delivered 43 decisions, 34 of which were made public.[19] The number of cases that reached completion totalled 356 by the end of 2014; 37% were resolved in favour of the state, 25% in favour of the investor, and 28% were settled by the parties.[20]

According to UNCTAD, 23 complaints against Canada went to arbitration, placing the country fifth behind Argentina (56), Venezuela (36), the Czech Republic (29) and Egypt (24).[21]

With regards to the nationality of claimants, Canadian investors filed 35 complaints, tying the country with France for fifth place behind the United States (134), the Netherlands (69), the United Kingdom (49) and Germany (42).[22]

4 CRITICISM

ISDS mechanisms have been criticized for a variety of reasons. Some of the most common are presented in this section.

4.1 Regulatory Chill

As mentioned earlier, although they offer a framework for settling disputes between investors and states, ISDS arbitration tribunals do not have the authority to overturn national laws and regulations. However, some observers believe that while ISDS mechanisms do not challenge the sovereign power of states to regulate, the possibility of a case being initiated and a financial burden resulting from it could create a "regulatory chill" or, in other words, a reluctance by governments to make new regulations.

One example of regulatory chill is the New Zealand government's decision in 2013 to delay implementation of tobacco plain packaging legislation until an arbitration tribunal had ruled on a case concerning cigarette packaging brought by Philip Morris Asia against Australia.[23] The New Zealand Associate Minister of Health at the time stated as follows:

> In making this decision, the Government acknowledges that it will need to manage some legal risks. As we have seen in Australia, there is a possibility of legal proceedings.
>
> To manage this, Cabinet has decided that the Government will wait and see what happens with Australia's legal cases, making it a possibility that if necessary, enactment of New Zealand legislation and/or regulations could be delayed pending those outcomes.[24]

This statement shows that governments may consider possible challenges by foreign investors and the resulting financial obligations when contemplating legislation or regulations in certain areas, such as environmental protection or public safety. However, it is difficult, if not impossible, to determine the extent of this phenomenon.

It is interesting to note that developed countries that have concluded agreements with an ISDS mechanism have lost very few cases so far. For example, the EU, as a supranational body, has never had an ISDS claim filed against it, while the United States, which has been the subject of ISDS proceedings, has never lost a case. This could indicate that while a regulatory chill exists, it has been fairly limited so far.[25] It is also possible that developed countries have lost fewer cases precisely because they have refrained from introducing measures that they felt were too risky.

However, it is conceivable that the risk of an ISDS claim by a foreign investor is more of a deterrent to developing countries that have fewer resources to defend themselves fully against a foreign multinational.[26]

4.2 Transparency

Other criticisms of ISDS mechanisms are that they are not sufficiently transparent and the members selected for the arbitration tribunals are not fully impartial, particularly since some of them also act as legal advisors in other cases.

In recent years, the two principal bodies responsible for administering arbitration proceedings, the International Centre for Settlement of Investment Disputes and the United Nations Commission on International Trade Law, have taken steps to promote greater transparency in the international arbitration of investment disputes.[27]

The Government of Canada publishes the pleadings, hearings and decisions related to any ISDS mechanisms in which it is involved. However, the provisions of some of Canada's FTAs and FIPAs can sometimes restrict full transparency. For example, article 28 of the *Agreement Between the Government of Canada and the Government of the People's Republic of China for the Promotion and Reciprocal Protection of Investments*[28] allows the disputing contracting party to require that documents submitted to or issued by the arbitration tribunal – except for the award determined by the tribunal – be made public and that the ISDS hearings remain confidential.[29]

4.3 Indirect Expropriation

It is also claimed that ISDS tribunals sometimes favour investors by interpreting certain provisions in investment agreements too broadly.

Indirect expropriation is an example of a controversial aspect of investment agreements. Indirect expropriation can be defined as "a measure or series of measures of a Party that has an effect equivalent to direct expropriation without formal transfer of title or outright seizure."[30] Critics of ISDS mechanisms believe this definition is dangerous because it creates an opportunity for foreign companies to bring claims against governments for adopting policies or legislation that restrict their profits.[31]

The investment protection provisions that Canada has negotiated have changed over time to reflect this criticism. For example, Chapter 10, Annex X.11, article 3, of the Canada–EU CETA seems to have been drafted so as to limit the circumstances in which an investor could be compensated for an alleged indirect expropriation:

> For greater certainty, except in the rare circumstance where the impact of the measure or series of measures is so severe in light of its purpose that it appears manifestly excessive, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriations.[32]

4.4 Fair and Equitable Treatment

Interpretation of the principle of fair and equitable treatment of investors and investments has also been criticized for its variability from one tribunal to the next.

According to the Organisation for Economic Co-operation and Development, government officials, arbitrators and scholars have given various interpretations to the obligation to provide fair and equitable treatment over the years.[33] A broad interpretation of this principle is problematic for states that must defend themselves against foreign investors.

In Canada's current FTAs, the fair and equitable treatment provisions have a fairly general scope (for example, NAFTA refers to "treatment in accordance with international law"). However, the proposed provision in the Canada–EU CETA is more precise and stipulates what would constitute unfair and inequitable treatment.[34] In this way, Canada and the EU appear to be giving tribunals clear guidelines in order to prevent overly broad interpretations.

5 THE FUTURE

Based on their experiences and in response to criticisms of ISDS mechanisms, some countries have decided to review their position on including ISDS provisions in their investment agreements.

Several developing countries appear to be leading this shift in approach:

- South Africa has begun to terminate some of the investment treaties it had concluded previously and has introduced legislation to modernize its investment protection regime and ensure that all investors are treated consistently.
- In recent years, India and Indonesia have declared that they are seeking to amend some of their investment agreements.[35]
- Bolivia, Ecuador and Venezuela have withdrawn from the ICSID Convention in the past decade.[36]
- Brazil has never ratified any of its investment treaties.[37]

Given the actions of these and other countries, and the growing criticism of ISDS mechanisms, it seems inevitable that the traditional approach to ISDS will change. In its 2015 annual report on international investment, UNCTAD stated that maintaining the status quo hardly remains an option, given the degree of criticism aimed at the current system.[38]

UNCTAD proposed two principal alternatives. The first is to maintain the basic structure of ISDS mechanisms but introduce specific reforms, such as these:

- Make the process more transparent;
- Allow for the early discharge of frivolous claims;
- Exclude certain types of claims from the ISDS process; and
- Channel sensitive cases to state-to-state dispute settlement.

UNCTAD cited the provisions in the 2014 Canada–EU CETA as an example of the types of reforms that can be made to traditional ISDS mechanisms. Another possible reform measure would be to introduce an appeal mechanism for tribunal decisions.

The second alternative is to abolish ISDS mechanisms. Naturally, this would not eliminate disputes between states and foreign investors. States could decide to take the following measures to settle these disputes:

- Allow domestic courts to hear complaints from foreign investors;
- Replace the ISDS system with state-to-state dispute settlement; and
- Establish a standing international investment court.

Judging from its most recent agreements – with the EU, South Korea and other nations in the Trans-Pacific Partnership – Canada still seems to believe that ISDS is a useful process. However, Canada's intention to modernize its approach is evident

in the provisions of these agreements. For example, including provisions to allow amicus curiae[39] interventions or the early dismissal of frivolous claims seems to be a response to criticisms of ISDS mechanisms over the past few years. The provisions in the Canada–EU CETA that pave the way to a possible appeal procedure and a code of conduct for ISDS arbitrators also seem to be a move in this direction.[40]

6 CONCLUSION

ISDS mechanisms have a long history and are used frequently by investors around the world. The number of ISDS cases is relatively low in relation to international foreign investment flows. However, the number of cases brought before an ISDS tribunal has been increasing since the 1990s, and this trend shows no sign of reversing. Criticism of ISDS is also on the rise.

Some countries have responded to this criticism by reviewing their approach to ISDS mechanisms, and some have gone so far as to rescind agreements containing such mechanisms. Others, such as Canada, have signed agreements with provisions that, among other things, should make ISDS mechanisms more transparent and allow frivolous claims to be rejected early. Only time will tell whether these new provisions will address concerns over ISDS mechanisms.

NOTES

1. Global Affairs Canada, "Canada–European Union: Comprehensive Economic and Trade Agreement (CETA)," *Consolidated CETA Text*.
2. United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2015 – Reforming International Investment Governance*, 24 June 2015.
3. The *Convention on the Settlement of Investment Disputes between States and Nationals of Other States* (ICSID Convention) came into force in Canada on 1 December 2013.
4. Regarding cases brought under the ICSID Convention, for example, article 54(1) of the Convention stipulates that:

   > Each Contracting State shall recognize an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State.

5. UNCTAD, "Recent Trends in IIAs and ISDS," *IIA Issues Note*, No. 1, February 2015.
6. These FTAs do not include the *Canada–United States Free Trade Agreement*, which was replaced by the *North American Free Trade Agreement* in 1994.
7. Although the Canada–EU CETA and the Trans-Pacific Partnership FTA have not been signed and ratified, they also provide for an investor–state dispute settlement (ISDS) mechanism.
8. Global Affairs Canada, "Cases Filed Against the Government of Canada," *NAFTA – Chapter 11 – Investment*.
9. Global Affairs Canada, *Text of the North American Free Trade Agreement (NAFTA)*. Several of these notices have been withdrawn or are inactive.

10. UNCTAD, *Investment Dispute Settlement Navigator*, database, consulted 9 October 2015.

11. Global Affairs Canada, "*S. D. Myers Inc. v. Government of Canada*," *NAFTA – Chapter 11 – Investment: Cases Filed Against the Government of Canada*.

12. Global Affairs Canada, "*Pope & Talbot Inc. v. Government of Canada*," *NAFTA – Chapter 11 – Investment*: *Cases Filed Against the Government of Canada*.

13. Global Affairs Canada, "*Mobil Investments Inc. and Murphy Oil Corporation v. Government of Canada*," *NAFTA – Chapter 11 – Investment*: *Cases Filed Against the Government of Canada*; and "*Clayton/Bilcon v. Government of Canada*," *NAFTA – Chapter 11 – Investment*: *Cases Filed Against the Government of Canada*.

14. Global Affairs Canada, "*Ethyl Corporation v. Government of Canada*," *NAFTA – Chapter 11 – Investment*: *Cases Filed Against the Government of Canada*; "*AbitibiBowater Inc. v. Government of Canada*," *NAFTA – Chapter 11 – Investment*: *Cases Filed Against the Government of Canada*; and "*St. Marys VCNA, LLC v. Government of Canada*," *NAFTA – Chapter 11 – Investment*: *Cases Filed Against the Government of Canada*.

15. UNCTAD, "Investor–State Dispute Settlement: Review of Developments in 2014," *IIA Issues Note*, No. 2, May 2015.

16. Ibid.

17. UNCTAD (24 June 2015).

18. See Center for Strategic and International Studies, *Investor–State Dispute Settlement: A Reality Check*, Working Paper, 21 January 2015.

19. Ibid.

20. Ibid.

21. Ibid.

22. UNCTAD, *Investment Dispute Settlement Navigator*. The total number of complaints per country includes complaints by foreign countries that have been combined into one case.

23. See Government of Australia, *Tobacco plain packaging – investor–state arbitration*.

24. Government of New Zealand, *Government moves forward with plain packaging of tobacco products*, 19 February 2013.

25. See Armand de Mestral, *Investor–State Arbitration Between Developed Democratic Countries*, Investor–State Arbitration Series, Paper No. 1, September 2015.

26. Ibid.

27. See United Nations Commission on International Trade Law, *UNCITRAL Rules on Transparency in Treaty-based Investor–State Arbitration (effective date: 1 April 2014)*; and Jason W. Yackee and Jarrod Wong, *The 2006 Procedural and Transparency-Related Amendments to the ICSID Arbitration Rules: Model Intentions, Moderate Proposals, and Modest Returns*, 12 January 2011.

28. Global Affairs Canada, *Agreement Between the Government of Canada and the Government of the People's Republic of China for the Promotion and Reciprocal Protection of Investments*.

29. See also Pascal Tremblay, *Canada–China: Foreign Investment Promotion and Protection Agreement comes into force*, HillNotes, Library of Parliament, 30 September 2014.

30. Global Affairs Canada, "Interpretation of Article G-10," *Canada–Chile Free Trade Agreement: Decision of the Canada–Chile Free Trade Commission*.

31. *Metalclad Corporation v. The United Mexican States* (ICSID Case No. ARB (AF)/97/1) is often cited as an example of the dangers of an overly broad interpretation of indirect expropriation. In this instance, the arbitration tribunal ordered the Mexican government to pay US$16.7 million (the award was reduced slightly after the interest was recalculated) after Metalclad Corporation was prohibited from proceeding with a landfill site in Mexico after first receiving the necessary approvals from the Mexican federal government and investing in the site based on these approvals.

32. Global Affairs Canada, "10. Investment," *Consolidated CETA Text*.

33. Organisation for Economic Cooperation and Development (OECD), *Fair and Equitable Treatment Standard in International Investment Law*, OECD Working Papers on International Investment, No. 2004/03, September 2004.

34. See Chapter 10, article X.9(2) of the Canada–EU CETA:

> A Party breaches the obligation of fair and equitable treatment referenced in paragraph 1 where a measure or series of measures constitutes
>
> a) Denial of justice in criminal, civil or administrative proceedings;
>
> b) Fundamental breach of due process, including a fundamental breach of transparency, in judicial and administrative proceedings;
>
> c) Manifest arbitrariness;
>
> d) Targeted discrimination on manifestly wrongful grounds, such as gender, race or religious belief;
>
> e) Abusive treatment of investors, such as coercion, duress and harassment; or
>
> f) A breach of any further elements of the fair and equitable treatment obligation adopted by the Parties in accordance with paragraph 3 of this Article.

35. Kathryn Gordon and Joachim Pohl, *Investment Treaties over Time – Treaty Practice and Interpretation in a Changing World*, OECD Working Papers on International Investment, No. 2015/02, February 2015.

36. Ibid.

37. Ibid.

38. UNCTAD (24 June 2015).

39. An *amicus curiae* is a professional person or organization that is not a party to a particular litigation but that is permitted by the court to advise it in respect to some matter of law that directly affects the case in question.

40. See Canada–EU CETA, Chapter 10, article X.42.