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Decisions about whether to include investor-state arbitration clauses in investment treaties should fully consider the policy trade-offs: state consent to arbitration may expose the state to investor claims affecting wide-ranging policy areas.

Developments in investment treaties and arbitration illustrate how transparency can be increased, and how civil society can raise public-interest issues in arbitration proceedings.

There is growing international debate on reforming investor-state arbitration. It is crucial that governments and civil society from low-income countries help drive the reform agenda, so ensuring it responds to their concerns and aspirations.

Investment treaties and sustainable development: investor-state arbitration

Many of the world's 3,000+ international investment treaties (IITs) allow investors to take host country governments to international arbitral tribunals, where decisions are binding and enforceable within and beyond state boundaries. Such provisions, which have considerable financial implications for countries, reassure foreign investors they will not suffer unfair state action. But states have been challenged on issues they consider their right to regulate, including taxation, environmental protection and public health. Historically, arbitrations have emphasised confidentiality, and this is at odds with the public scrutiny appropriate for public policy issues. Some states are increasingly cautious in consenting to investor-state arbitration, and reforms have increased transparency in some arbitration rules. Policy choices on arbitration require careful consideration of costs and benefits. This is the fourth of four briefings promoting debate on IITs and sustainable development.

What is investor-state arbitration?

Investor-state arbitration settles disputes between an investor and a host state using an international arbitral tribunal. Most of the over 3,000 IITs in force worldwide allow investors to take disputes to arbitration. The investor typically alleges that the state has violated the treaty, and will usually seek compensation. The tribunal issues a binding award — effectively a document similar to a court judgment.

The compensation amounts awarded to investors can be very large. The highest known award is for US$1.7 billion.[1] Even if a government wins, it may have to cover its own substantial legal costs. And arbitral awards are backed up by relatively effective enforcement mechanisms that help investors get the money they have been awarded (discussed below). So arbitration can have serious financial implications.

Investor-state arbitration has become more frequent in recent years. By the end of 2012, 514 publicly known cases had been brought under IITs. In 2000 the number was below 50.[2] Many more arbitrations are not made public, or are based on contracts or laws rather than treaties.

There has been much debate about reforming investor-state arbitration. Several of the concerns raised are ultimately rooted in the fact that international arbitration emerged primarily as a mechanism to settle commercial disputes between private parties. In the 1960s, efforts to promote foreign investment, stop investor-state disputes escalating into disputes between states, and minimise the risk of powerful states bullying poorer nations led states to extend arbitration to state-investor disputes.

But investor-state disputes differ from business disputes because public policy is often at stake. This difference has often been overlooked but has important implications. For example, while commercial arbitration emphasises confidentiality, some degree of transparency and public scrutiny is desirable in investor-state arbitration. Recent efforts to reform investor-state arbitration, discussed below, have differentiated some types of investor-state arbitration more strongly from commercial arbitration.

Low-income countries must drive the reform agenda to ensure it meets their concerns

Arbitration rules and procedures

Investor-state arbitration can be conducted under different sets of rules. One prominent institution is the World Bank-hosted International Centre for the Settlement of Investment Disputes (ICSID). ICSID was established through a treaty among states — the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the 'ICSID Convention').

Strictly speaking, ICSID only deals with disputes between investors and states where both home and host states are parties to the ICSID Convention. However, the ICSID 'Additional Facility' Rules extend the application of most ICSID rules to cases where either the host state or the home state is not a party to the convention.

Private bodies like the International Chamber of Commerce, the London Court of International Arbitration, the Stockholm Chamber of Commerce or the Hong Kong International Arbitration Centre administer other arbitration rules. Unlike ICSID, these institutions are mainly concerned with business disputes between private parties, but are also used for investor-state disputes. Each institution has its own procedural rules.

Arbitrations can also be carried out outside any standing institutions (so-called 'ad hoc arbitration'), often following the rules adopted by the United Nations Commission on International Trade Law (UNCITRAL Arbitration Rules).

Under most arbitration rules, a panel of three arbitrators is appointed by the parties to settle the dispute. Often, one arbitrator is appointed by each party, and the chair is either jointly appointed by the two parties or by the party-appointed arbitrators. People appointed as arbitrators are usually private lawyers or legal academics. Once the arbitration is completed, the tribunal disbands. Arbitrators can be appointed even where one party refuses to cooperate, so arbitral proceedings can continue even if the host government does not take part.

Despite important variations, arbitral proceedings typically involve: a commencement stage; constitution of the tribunal; submissions of pleadings and evidence; an oral hearing and sometimes further written submissions; possible settlement discussions; an award decision and, if necessary, challenges to or enforcement of the award.[3]

How arbitral awards are enforced

In contrast to the judgments of domestic courts, global treaties regulate the enforcement of arbitral awards. The 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards requires over 140 states parties to recognise awards as binding and to enforce them within their jurisdiction. States can only refuse enforcement if major defects affected the arbitral proceedings, or where enforcement would be contrary to the public policy of the country.

Similarly, the ICSID Convention commits states to recognise its tribunals' awards as binding and requires states to enforce awards as if they were final judgements issued by their own courts. The ICSID Convention does not contain an exception like the New York Convention. However, it does provide some narrowly defined grounds for annulling an award through a special procedure before an 'ad hoc committee'.

If a host state fails to comply with an ICSID award or with an award covered by the New York Convention, the investor may seek enforcement through the national courts of a third signatory country where the host state holds interests, for instance by seizing goods or freezing bank accounts (see Box 1). However, immunity rules for assets held by states in their sovereign capacity may hinder such enforcement strategies.

Reliable, systematic data on government compliance with arbitral awards is hard to come by. There have been cases where governments have challenged the award or have refused to pay the compensation. But states are usually under intense pressure to pay up — both because of the legal arrangements backing up enforcement, and to avoid discouraging prospective investors. So arrangements concerning investor-state arbitration have serious financial implications.

The 'backlash' against arbitration

Investors may prefer international arbitration over the domestic courts of the host state where, depending on the country, the judicial process may risk political interference or involve cumbersome and lengthy procedures.

But state action challenged before arbitral tribunals includes measures that many governments consider to be within their sovereign right to regulate, including taxation, environmental protection and public health (see our related briefing on investment protection). Measures to introduce or extend performance requirements have also exposed states to arbitration claims (see the briefing on investment liberalisation). Commentators have raised concerns that arbitral tribunals tend to interpret IITs in expansive ways, thereby tightening restrictions on policy space.

So some governments have moved to limit their exposure to investor-state arbitration, in a development sometimes dubbed the 'backlash' against arbitration. For example, experience with investor-state arbitrations has led Bolivia, Ecuador and Venezuela to withdraw from the ICSID Convention, while other countries have terminated several IITs (for example, South Africa and Indonesia).

In 2011, the Australian government announced that it would not include investor-state arbitration clauses in future IITs, though a new government in 2013 stated that it would deal with the issue on a case-by-case basis. A recent treaty between Australia and Japan does not feature investor-state arbitration, while another Australian IIT with South Korea includes arbitration but reportedly excludes certain policy areas, for instance environmental protection and public health.

In Europe, proposals to include an investor-state arbitration clause in the ongoing negotiation of a EU-US Transatlantic Trade and Investment Partnership treaty has triggered much civil society advocacy. In response, the EU has launched a public consultation on this matter, and recent developments suggest that some EU member states no longer support the inclusion of investor-state arbitration in the treaty.

Careful consideration is needed

Given the major ramifications involved, choices about whether to agree to investor-state arbitration in IITs require careful consideration of both costs and benefits. As a broad generalisation, countries with effective and independent judiciaries may have less to lose from not consenting to arbitration, because investors may be more prepared to trust national courts.

If arbitration is allowed, details matter. Some investment treaties allow investor-state arbitration but also include devices aimed at limiting state exposure to liabilities. For example, some treaties stipulate that arbitration cannot proceed before domestic litigation or conciliation is pursued either for specified periods, or even to exhaustion of domestic remedies.

Also, some IITs require investors to bring any claims within a specified period of time, for instance three years, so as to prevent liabilities accumulating. Other IITs exclude certain treaty provisions from the application of investor-state arbitration.

Some countries have established national institutions to minimise exposure to lawsuits, and to handle cases effectively where arbitration cannot be avoided (see Box 2).

Reducing uncertainties in how investment protection standards in investment treaties are formulated and interpreted is also critical in limiting exposure to arbitration (see our related briefing on investment protection).

Transparency and public input in arbitration proceedings

In many arbitrations, much more is at stake than purely commercial matters. This is not simply because awards are paid from the public purse but also because public policy and third-party interests may be affected.

Indeed, investment disputes can arise from action that the government or courts in the host country take to protect a public interest, or the interests of local groups who feel they have been adversely affected by an investment project. Transparency,

Box 1. Seizing the prince's plane

In 2011, arbitral awards made the headlines when agents for an international construction firm seized a plane used by the Thai crown prince after it landed in Germany. The company was seeking enforcement of a ruling against the Thai government. Reportedly, the government argued that the plane was owned privately by the prince, but the plane was only released after the government offered a substantial bank guarantee.[4]

Because in our globalised world most states hold assets overseas, this type of legal action can provide effective enforcement.

Box 2. Handling arbitration: lessons from Peru

Peru has established a response system to deal with investor-state arbitration. The system involves an inter-ministerial commission and technical secretariat that represent the state in investment disputes, early alerts to identify disputes and so reach settlement before escalation, and it has funds allocated for legal costs and specialised advice. The United Nations report that the system has made government action better at both preventing arbitration and handling cases.[5]

public scrutiny and civil society submissions are crucial in ensuring that these wider considerations are taken seriously.

Many arbitration proceedings are private, however. In several cases, procedural rules ban the public from oral hearings and stop publication of information concerning the dispute. There may also be restrictions on the public's ability to make submissions and draw the tribunal's attention to matters of public policy.

Different arbitration rules vary considerably in this respect, and some have recently evolved significantly, moving towards greater transparency and public scrutiny. This includes changes to arbitration rules, and shifts in investment treaty practice.

The ICSID Arbitration Rules were amended in 2006 to increase public scrutiny. For example, the amended rules empower tribunals to accept civil society submissions, and tribunals have accepted such submissions in several disputes relating to water supply contracts and extractive industries. But access to hearings remains subject to the parties' consent and has been denied in some cases.

In 2013, the United Nations Commission on International Trade Law (UNCITRAL) adopted new rules on transparency in investor-state arbitrations. These rules allow disclosure of key case documents; empower arbitral tribunals to accept civil society submissions; and require open hearings, subject to exceptions.

Shifts in investment treaty practice are also helping increase transparency in arbitration. Some recent treaties concluded by the US and by Canada contain detailed provisions regulating access to arbitration that would apply independently of the chosen set of arbitration rules.

These treaty clauses boost transparency in arbitration and allow civil society submissions where specified criteria are met. Some also require open hearings and publicly available documents, though they typically feature exceptions for confidential information.

All these are positive developments but much remains to be done. Only a small share of arbitrations to date have been brought under IITs that require transparency in arbitration. More rigorous evidence is needed on the extent to which civil society submissions make a difference. Some arbitration rules still provide very little transparency. In these cases, the public may not even know that an arbitration is ongoing.

In addition, the real effects of the new UNCITRAL transparency rules are still unclear. These rules only apply automatically to investor-state arbitrations filed under IITs concluded after 1 April 2014 — unless the parties to a dispute (investor and state), or two states parties to a pre-2014 investment treaty, explicitly 'opt into' the new rules. Given that there are already over 3,000 IITs, the new rules are unlikely to make a significant difference in the short term without substantial levels of 'opting in'.

Lower-income countries should help drive the reform agenda

Beyond policy choices about IITs, there is growing international debate about ways to reform investor-state arbitration systematically. For example, some commentators have proposed an appeals system or even a standing investment court, and there has been much debate about how to address potential conflicts of interest in arbitral proceedings. UNCITRAL is considering developing a multilateral convention on transparency in investor-state arbitration.

These debates have so far been dominated by legal professionals and high-income countries. It is essential that government and civil society from low-income countries also drive the reform agenda to ensure it meets their concerns and aspirations.

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This briefing is part of a set of four aimed at promoting debate on investment treaties and sustainable development. Other briefings in the set cover the following topics:

Overview: http://pubs.iied.org/17238IIED

Investment protection: http://pubs.iied.org/17239IIED

Investment liberalisation: http://pubs.iied.org/17240IIED

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Notes

[1] Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador. Award. 5 October 2012, ICSID Case No. ARB/06/11, http://italaw.com/sites/default/files/case-documents/italaw1094.pdf / [2] Figures from United Nations Conference on Trade and Development (2012) World investment report 2012: towards a new generation of investment policies. http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/WIR2012_WebFlyer.aspx; and UNCTAD (2013) World investment report 2013: global value chains investment and trade for development. http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf / [3] Delaney, J and Barstow Magraw, D (2008) Procedural transparency. In: Muchlinski, P *et al.* (eds) *The Oxford Handbook of International Investment Law.* Oxford University Press, Oxford and New York, pp. 728-729 / [4] Jolly, D and Fuller, T (13 July 2011) Thai prince's plane is impounded in Germany. New York Times. https://tinyurl.com/65wwxak; and Fuller, T (12 August 2011) A Thai jet is free to go, but larger questions of ownership linger. New York Times https://tinyurl.com/3gl4pau / [5] UNCTAD (2011) Best practices in investment for development – how to prevent and manage investor-state disputes: lessons from Peru.