

## Possible Reform of Investor-State Dispute Settlement (ISDS): The assessment of damages and compensation<sup>1</sup>

Submission to UNCITRAL Working Group III on ISDS Reform, contributed by the Columbia Center on Sustainable Investment (CCSI), the International Institute for Environment and Development (IIED), and the International Institute for Sustainable Development (IISD)

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### 1. Introduction

States have increasingly raised concerns about the calculation of damages and the award of ever greater sums of compensation in investor-state dispute settlement ('ISDS'). At the 38<sup>th</sup> Session of the UNCITRAL Working Group III on ISDS Reform (the 'Working Group'), states represented in the Working Group ('Members') requested that the UNCITRAL Secretariat (the 'Secretariat') explore ways to work on this issue.<sup>2</sup> Based on this mandate, the Secretariat prepared a [note](#) on assessment of damages and compensation (the 'Note') and solicited comments from Members and observers. This joint submission contributes comments in response to the Secretariat's request.

By way of preliminary remarks, we welcome the formalization of the inclusion of this important topic in the Working Group's agenda. Assessment of damages and compensation falls squarely within the Working Group's remit: remedy involves major procedural dimensions, and questions about damages link closely to other concerns and crosscutting issues the Working Group has identified, such as costs and 'regulatory chill'. Indeed, the amount of compensation awarded by arbitral tribunals influences the impact of ISDS on states' regulatory and fiscal space. In addition, the calculation of damages has become the object of diverse jurisprudential approaches, compounding concerns about consistency and predictability. Beyond rules governing compensation in specific circumstances (such as lawful expropriation and losses suffered owing to armed conflict), most bilateral and regional investment treaties are silent on the standards applicable to damages resulting from treaty breaches. This creates the opportunity for a multilateral reform instrument that can bring clarity and consistency to

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<sup>2</sup> The deliberations and decisions of Working Group III at the thirty-eighth session are set out in document A/CN.9/1004. Document A/CN.9/WG.III/WP.166 provides an overview of reform options.

this area of law. It is hard to imagine an effective reform outcome that does not meaningfully engage with damages issues.

We commend Members and the Secretariat for the quality of the reflection conducted so far, both during Working Group sessions and in the Note. The Note rightly highlights the complexity of current practice, the rapid increase in the amounts of compensation, discrepancies between amounts claimed and awarded, and the divergence in expert calculations of damages, among other issues. This analysis presents important points of convergence with our identification of the problems arising in the context of the issue of damages and compensation.<sup>3</sup> We would add that global challenges such as the policy imperative to address climate change are now compounding the urgency of action to address damages issues: as fossil fuel phase-outs are starting to trigger ISDS claims, concerns are being raised that large compensation bills and unpredictable outcomes can make it more costly, and thus difficult, for states to take necessary climate action.<sup>4</sup> A swift and fundamental overhaul of the principles governing compensation is now required. The interrelatedness of issues calls for a holistic approach that considers questions about damages within the wider reform agenda. Narrow technical responses to discrete problems will not address the significant concerns at stake.

In the light of these considerations, we would encourage the Working Group to deepen work on all the issues and areas mentioned in paragraphs 70, 74–75, 79, and 82–85 under Section D of the Note (“Matters for consideration and possible work”), including issues we do not specifically address in this submission. We would however caution against the use of restitution in an ISDS context (paragraph 70(x) of the Note) and consider that a reduction of compensation would not need to be limited to cases of contributory fault (paragraph 70(iv)). The remaining sections of this submission provide a few more specific comments on Section D of the Note and suggestions on additional themes the Working Group may wish to consider integrating into its work program.

## **2. Comments on the Proposals in the Note**

We organize our comments following the structure of Section D of the Note, namely as regards to possible future work the Note discusses under its subheadings on “The complexity and uncertainty under current practice”, “Valuation methods, including calculation of interest”, “Discrepancy between compensation claimed and awarded” and “Divergence of expert damage calculations”. We also recognize however that the issues are closely interlinked in practice.

### **i) The complexity and uncertainty of the current practice**

#### *Binding vs. non-binding instrument*

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<sup>3</sup> See, e.g., Bonnitcha, J. & Brewin, S. (2020): Compensation under Investment Treaties, IISD Best Practice Series, November 2020, <https://www.iisd.org/system/files/publications/compensation-treaties-best-practices-en.pdf>

<sup>4</sup> Tienhaara, K., and Cotula, L. (2020) Raising the Cost of Climate Action? Investor-State Dispute Settlement and Compensation for Stranded Fossil Fuel Assets, International Institute for Environment and Development (IIED), <https://pubs.iied.org/sites/default/files/pdfs/migrate/17660IIED.pdf>

The way in which arbitral tribunals currently determine damages and calculate compensation is highly complex, often inconsistent and marked by significant legal uncertainty. Reflecting on ways to implement reform in this area, paragraph 70 of the Note suggests that states may “wish to consider whether to undertake work on the development of treaty provisions, guidelines, or standards for tribunals to address the following issues”. In our view, a legally binding multilateral treaty that clarifies, integrates, or amends the provisions of existing bilateral and regional treaties would be the most effective means to address problems linked to compensation.

The calculation of damages and awarding of compensation is a key feature of investor-state dispute settlement, yet also a gap in most investment treaties. Therefore, non-binding guidelines or standards can also provide clarity on areas not currently covered by existing treaties. This could assist tribunals in adjudication and states in reforming existing bilateral and regional treaties. However, a non-binding instrument would not carry the same legal weight and might be less effective in shifting entrenched dispute settlement practices.

#### *A holistic revision of the standard of compensation*

The Note sets out issues that a reform could address, including “a clarification of the applicable standard for cases of non-expropriatory breaches” (paragraph 70(i)). We agree that such a clarification would be helpful, as the issue of damages for non-expropriatory breaches is often not addressed in investment treaties.<sup>5</sup> Members could also consider whether an entirely new standard is required, for example to consider market value alongside other parameters such as the nature of the public interests at play and the history of the investor’s acquisition of its assets.

#### *Restricting the use of Discounted Cash Flow (DCF)*

The Note suggests that work be undertaken to address the “valuation method to be applied by the tribunal, in particular cases in which the application of the DCF method is appropriate” (paragraph 70(ii)). The DCF method is widely considered to be problematic due to the speculative nature of its assumptions and arbitral tribunals’ inconsistent approach to the assessment of country and other risks.<sup>6</sup> According to the International Law Commission’s (ILC) Articles on State Responsibility, the DCF method is based on “a wider range of inherently speculative elements, some of which have a significant impact upon the outcome”.<sup>7</sup> Options to be considered include a ban on or guidance against use of DCF in cases of early-stage investments without a history of business operations.

#### *Limiting compensation based on investor conduct*

Besides calculation techniques, the Note suggests that Members consider “[p]otential limitations for compensation, in particular the consideration of the claimant’s conduct before the breach” (paragraph 70 (iv)). We think that this is an important area of work for the Working Group to pursue, but would emphasize that work to consider claimants’ conduct at the damages

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<sup>5</sup> See Bonnitca, J. & Brewin, S. (2020): Compensation under Investment Treaties, IISD Best Practice Series, November 2020, p. 11.

<sup>6</sup> See *id.*, p. 19.

<sup>7</sup> International Law Commission. (2001). Text of the articles on the responsibility of states for internationally wrongful acts. Yearbook of the International Law Commission, 2001, II (Part Two). UN Doc. A/56/10, art. 36, cmt. 26 [Hereinafter the ILC Articles].

phase should not prejudice or be seen to prejudice efforts to consider such conduct in the jurisdictional or merits phases. When considering these issues, Members could specifically refer to claimants' compliance with multilateral instruments, such as the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises.<sup>8</sup>

#### *Retaining the use of restitution as inappropriate in regulatory cases*

The Note refers to possible work in the area of “[t]he primacy of restitution over compensation, as stated in the ILC Articles” (paragraph 70(x)). As defined in the ILC Articles, restitution refers to remedies that re-establish the situation that existed prior to the breach of international law, through the specific performance of an action by the state, such as the return of an asset taken or the reversal of a measure. In the context of ISDS, restitution could for instance entail an arbitral tribunal's order that a state return wrongfully expropriated property to an investor (potentially taking property rights from another actor not party to the ISDS proceedings in order to do so), or that a state repeal legislation deemed to breach the investment treaty.

We consider an application of this principle in the context of ISDS to be highly problematic.<sup>9</sup> Indeed, restitution seems largely inappropriate and impractical in any ISDS case for a number of reasons. First, and in contrast to trade, ISDS cases typically deal with “behind-the-border” issues; second, restitution in the ISDS context may conflict with internal systems of governance and separation of powers; and third, restitution may generate heightened risks that the resulting awards will unduly interfere with the property and other rights of non-parties.<sup>10</sup> For these reasons, some existing treaty provisions limit the possibility of restitution to orders that the state return an investor's property with the option for the state to pay compensation in lieu.<sup>11</sup>

#### **ii) Valuation methods, including calculation of interest; discrepancy between compensation claimed and awarded; divergence of expert damage calculations**

Current valuation techniques and the growth of the expert industry have led to a drastic increase in the amounts of compensation awarded. We welcome the suggestions in the Note for the Working Group to consider work on the use of valuation methods, on “the capping of compensation, for instance to the amount actually invested by the investor”, and on integrating contextual factors in the calculation of compensation (paragraphs 74–75). We would additionally recommend that the Working Group consider looking at the compensation practices of political risk insurers, which may link compensation to a percentage of book value.<sup>12</sup>

Paragraphs 78 and 79 of the Note focus on “anchoring effects” and cost allocation. We welcome the inclusion of these critical issues, and think the matters worthy of consideration as part of the Working Group's broader efforts on this topic.

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<sup>8</sup> This is the approach taken by the Dutch Model BIT.

<sup>9</sup> See the forthcoming IISD paper on approaches to compensation taken by international courts and tribunals.

<sup>10</sup> See IISD, 2020, section 2.4.3.

<sup>11</sup> See for e.g., Singapore–Myanmar BIT (2019), Article 18(1).

<sup>12</sup> See, e.g., the approach of the US entity formerly known as the “Overseas Private Investment Corporation,” reflected in 51 Fed. Reg. 3438, 27 January 1986.

We consider a “generalized system of expert(s) appointed by the tribunal” (paragraph 82) to be an interesting proposition worthy of further consideration. A forthcoming IISD paper highlights the important role of court- or tribunal-appointed experts in other international fora such as the International Court of Justice. By following a similar approach, Members could bring ISDS closer in line with the practices of other international tribunals—and potentially reduce costs. Nevertheless, such a generalized system should not be considered a standalone solution, as has been noted in a recent practitioner-authored publication.<sup>13</sup> We are more skeptical of the alternative proposal according to which “treaty provisions or guidelines could be developed on the basis of the current system of party appointed experts” (paragraph 84). We consider that such an approach would not effectively counteract the built-in incentives and inherent bias of party-appointed experts.

The Note refers to Members’ ongoing discussion regarding “the binding interpretation of provisions in investment treaties on the assessment of damages as well as the calculation of the compensation, by the Parties to the treaty or by commissions formed under the treaties” (paragraph 89). The issue of treaty interpretation seems particularly important in the wake of the recent decision of the arbitral tribunal in *Eco Oro Minerals Corp. v. Republic of Colombia*, namely its interpretation of a widely used GATT Article XX-style exception and of possible related state obligations to pay compensation. We therefore welcome the suggestion in the Note and would encourage the Working Group to develop more elaborate proposals.

### 3. Suggested Additional Themes

Besides the proposals included in the Note, we would encourage the Working Group to explore the approaches taken by other international courts and tribunals with regards to the role of domestic courts in assessing damages. In applying Article 41 of the European Convention on Human Rights, the European Court of Human Rights has allowed for compensation to be determined through domestic mechanisms.<sup>14</sup> Furthermore, the Inter-American Court of Human Rights has directed the competent national bodies of the respondent State to determine the amount of compensation, in accordance either with domestic law,<sup>15</sup> or with “objective, reasonable and effective criteria”.<sup>16</sup> Considering this established practice, Members could explore a more deferential approach, and potentially a greater role for domestic courts, in the determination of compensation in investment disputes.<sup>17</sup>

In addition, the Working Group may wish to consider possible work in the areas of enhancing the transparency of awards and expert opinions on damages. It may also be timely to explore the appropriateness of requests for tax gross-ups to increase the amount of the award based on the assumption that tax will be collected on it.

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<sup>13</sup> Miles, C.S. ‘In defense of quantum,’ Columbia FDI Perspectives No. 315, October 4, 2021, <https://ccsi.columbia.edu/sites/default/files/content/docs/fdi%20perspectives/No%20315%20-%20Miles%20-%20FINAL.pdf>

<sup>14</sup> Scordino v Italy (No 1), Judgment, 29 March 2006, para 247.

<sup>15</sup> See ‘Five Pensioners’ v Peru, Judgment (Merits, Reparations and Costs) dated 28 February 2003, para 178.

<sup>16</sup> See Santo Domingo Massacre v. Colombia, Judgment (Preliminary Objections, Merits and Reparations), 30 November 2012, para 337.

<sup>17</sup> As argued by Bonnitcha, J. & Brewin, S. (2020), p. 36.