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BRIEFING 5:

International arbitration

Lorenzo Cotula, *International Institute for Environment and Development*[1]

This is the fifth of a series of briefings which discuss the sustainable development issues raised by legal arrangements for the protection of foreign investment. The briefings are based on legal research by IIED and its partners.[2] The goal is to provide accessible but accurate information for human rights, development and environmental organisations working on issues raised by foreign investment in low- and middle-income countries.

Briefing 5 explains how international arbitration works to resolve disputes between foreign investors and host states, and outlines some of the problems associated with its use, from a sustainable development perspective.

The past few years have witnessed a boom in the number of "international arbitrations" to resolve disputes between foreign investors and host states. Many of these arbitration proceedings are based on the provisions of investment treaties (see Briefing 2) and foreign investment contracts (see Briefing 4).

Increasingly, international arbitration has been used to solve disputes that raise important questions about public policy choices related to sustainable development. Yet international arbitration is principally designed to solve "commercial" disputes between investors and states. The rules that govern it have changed relatively little over the past few decades. Today, there are real risks that public interest considerations can get lost in the process, as this briefing explains further below. Rethinking aspects of arbitration processes is important if the contribution of foreign direct investment to sustainable development is to be maximised.

International arbitration in outline

In relation to investment disputes, international arbitration refers to the settlement of a dispute between the investor and the host state by an impartial third party – a sole arbitrator or, more commonly, a panel of (usually three) arbitrators.[3] The legal basis for international arbitration is provided by the terms of foreign investment contracts (the "arbitration clause") or of other legal instruments (e.g. domestic legislation or bilateral investment treaties – see Briefing 2). This web of routes into arbitration sometimes provides investors – or states – with a choice of arbitration forum, or of procedural rules to apply in resolving the dispute. The outcome of international arbitration is referred to as an arbitral "award" (effectively a judgment) that is binding for the parties.

There are two main kinds of international arbitral tribunals in investment disputes. "Ad hoc" tribunals are established to settle a specific dispute, usually involve a panel of three, and most commonly apply the procedural rules embodied in the 1976 UNCITRAL Arbitration Rules.[4] "Standing" tribunals are those attached to institutions that have been set up on a permanent basis (e.g. the International Centre for the Settlement of Investment Disputes (ICSID) and the Court of Arbitration of the International Chamber of Commerce). Ad hoc tribunals have been used to solve several major investment disputes (see for instance the *BP*, *Liamco*, *Texaco* and *Aminoil* awards), although recent years have witnessed growing use of standing tribunals such as ICSID.

When they adjudicate a dispute, arbitrators must apply the body of substantive law that has been chosen by the parties (e.g. in the investment contract). When the parties have not explicitly made such a choice, the applicable law is determined by looking to "conflict of law" rules (i.e. the norms of national and international law that determine which legal system governs a transaction); and by the rules regulating the arbitration (e.g. article 42 of the ICSID Convention, which requires arbitrators to apply the domestic law of the host state *and* relevant norms of international law). Arbitrators are not bound by precedent – i.e. previous judgments or arbitral awards. But in practice they do tend to take account of, and refer to, previous arbitral decisions.

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Investors tend to value international arbitration for a variety of reasons. First, it offers an alternative to resolving disputes in the domestic courts of the host state – where, depending on the country, there may be risks of political interference in the judicial process or cumbersome and lengthy procedures. For this reason, arbitration proceedings are particularly valued and used for investment in developing and transition economies – although bilateral investment treaties offer access to arbitration for nationals of both state parties, and regional treaties like the North American Free Trade Agreement (NAFTA) have enabled investors to bring arbitration proceedings against the US and Canada.

At the same time, "diplomatic protection", one of the main alternatives to arbitration (whereby the investor requests its home state to bring proceedings against the host state on its behalf, based on an alleged breach of international investment law[5]), may not provide adequate safeguards for the investor. As sovereign states themselves, home states enjoy wide discretion in deciding whether to act on the investor's behalf, and take political considerations into account when determining how to handle disputes.

International arbitration, on the other hand, is generally seen by investors as a reliable, quasi-judicial dispute settlement mechanism, which offers direct access to legal redress for the investor, follows flexible rules of procedure, ensures greater confidentiality than other kinds of judicial dispute settlement, and leads to a binding and enforceable decision (under the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards).

From a sustainable development perspective, international arbitration raises several challenges, which are discussed in the next sections.

Arbitration proceedings: an unfavourable setting for host states?

First, having to go through international arbitration rather than domestic courts may weaken the negotiating position of host states vis-à-vis foreign investors – and thereby possibly undermine the host state's capacity to pursue sustainable development goals even where this conflicts with the investor's interests.

The weakening of the host state's negotiating position is partly due to the costs associated with arbitration. International arbitration tends to be significantly more expensive than domestic litigation in most low and middle-income countries. In arbitral proceedings, parties to disputes must cover the arbitrators' fees and other costs associated with establishing an arbitral tribunal – costs that are not usually incurred in domestic litigation.

The legal expertise required to handle international arbitrations may also be more expensive than that usually required in many low and middle-income countries. In the case *Ceskoslovenska Obchodni Banka v Slovakia*, the tribunal ordered Slovakia to bear its own litigation costs (its counsel's fees and its share of tribunal costs), and to pay Ceskoslovenska Obchodni Banka $10 million as a "contribution" to its litigation costs. International arbitration may also lead to substantially higher amounts of compensation than those awarded by domestic courts. In *Ceskoslovenska Obchodni Banka*, the investor was awarded the record-setting amount of $867 million.

In addition, the host state's negotiating position may be undermined by the fact that arbitrators tend to be chosen among leading experts from commercial law firms, who may be more familiar with the needs of multinational companies – their main clients – than with those of host states (as argued by Cosbey et al, 2004). In this regard, it must be noted that the choice of the arbitrators can significantly influence the outcome of the arbitration. In practice, arbitrators enjoy a margin of discretion in identifying and interpreting relevant norms and in applying them to the facts of the case. This fact, coupled with the arbitrators' own value systems, may influence their decisions. On several occasions, different arbitrators have reached significantly different conclusions on disputes presenting very similar facts (e.g., in the parallel *Liamco* and the *Texaco* cases).

The fact that the great majority of arbitration proceedings were initiated by investors rather than by states reflects the nature of international arbitration, which is designed as a safeguard for investors against host state action. But it may also indicate the greater confidence that investors have in international arbitration proceedings.

Concerns about arbitration proceedings being an unfavourable setting for host states are even more acute given that, differently to court judgements, arbitral awards are not subject to appeal (ICSID arbitrations involve an annulment procedure, but only for major defects such as corruption or manifest excess of powers). If the host state fails to comply with the award, the investor may seek enforcement before the domestic courts of a third country where the host state holds interests, for instance through seizing goods or freezing bank accounts. Under the above-mentioned New York Convention, third-country courts must enforce the award – except where specific grounds invalidate the arbitral proceedings, or where enforcement would be contrary to the public policy of the third country. In most cases, this has put pressure on the host state to comply with the award or to settle the case. Non-compliance is likely to have major political and economic costs, for instance in terms of relations with the investor's home state, and of capacity to attract foreign investment.

Addressing public and third-party interests: the need for balanced expertise and open proceedings

A second challenge from a sustainable development perspective concerns the extent to which arbitration proceedings can effectively balance all the interests involved in the dispute – including both commercial and non-commercial interests. In many recent and ongoing arbitrations, what is at stake is much more than a purely commercial matter. Following waves of privatisation and economic liberalisation, for instance, basic public services such as water and sanitation in many countries are now provided by foreign investors. Several recent arbitrations concerning water concessions or privatisation schemes[6] have raised issues of great relevance to the progressive realisation of the right to water, which is protected under international law (Peterson and Gray, 2003). Investment disputes may also

arise from action by the host state to protect a public interest or the interests of third parties (e.g. environmental legislation, or norms in favour of indigenous communities). Because of these issues, the outcome of arbitration proceedings may significantly affect the lives of large numbers of people.

Taking these broader issues into account means ensuring that arbitral tribunals cover expertise in all the significant branches of law at stake, including investment, environmental and human rights law. Yet international arbitrators tend to come from a commercial law background, and may not be best placed effectively to take broader public or third-party interests into account.

Transparency and openness of international arbitration proceedings are also key to taking broader interests properly into account. Yet several commentators have criticised lack of transparency in arbitration proceedings. For example, the procedural rules of international arbitration usually entail restrictions on access to oral hearings, on the dissemination of information concerning the dispute, on the publication of the arbitral award, and on "third-party" submissions by civil society organisations and public interest lawyers who are not themselves party to the dispute ("*amicus curiae*" submissions; Cosbey et al, 2004).

The lack of procedural transparency is particularly an issue in ad hoc arbitrations, while standing arbitral tribunals (especially those under ICSID) have seen some positive developments in this regard. For instance, ICSID Arbitration Rules, as recently amended, empower arbitrators to allow persons not party to the dispute to file written submissions (Rule 37(2)); and, if the parties consent, to allow these persons to attend oral hearings (Rule 32(2)). In deciding whether to allow written submissions, arbitrators must consult the parties. They must also consider whether submissions are likely to assist in deciding the case, and whether the submission comes from a person or entity with a "significant interest" in the proceeding. Beyond these criteria, arbitrators enjoy considerable latitude.

In recent years, civil society organisations have filed written submissions under these rules, and ICSID arbitrators have been open to accepting them. Submissions from civil society organisations have for instance been allowed in *Biwater v Tanzania*. In this case, the arbitrators acknowledged that the arbitral proceedings raised not only commercial issues but also significant issues of public interest, which justified the filing of third-party submissions.

Access to oral hearings and to documents relating to the proceedings has proved more problematic, however, as it is subject to the parties' consent. If the investor and/or the state object, ICSID arbitrators have no power to permit civil society participation at the hearing (which is what happened in *Biwater v Tanzania* with regard to access to hearings).

As for arbitrations established under the North American Free Trade Agreement (NAFTA), a 2001 "Note of Interpretation" issued by the NAFTA Free Trade Commission improved public access to documents relating to arbitration proceedings, subject to protection of confidential business information. In addition, a 2003 Commission decision established a process for *amicus curiae* submissions – submissions first accepted in *Methanex v US*, a NAFTA case arbitrated on the basis of UNCITRAL rules.

Progress has also been made with regard to the dissemination of party pleadings and arbitral awards. ICSID awards are commonly published in law journals, and are available on the Internet – although publication of the award requires consent of the parties (article 48 of the ICSID rules).[7]

Despite these significant developments, transparency issues remain important both in standing arbitrations (for instance, with regard to access to oral hearings) and, even more so, in ad hoc arbitrations, which have not witnessed the improvements in transparency experienced by standing arbitrations. In ad hoc arbitrations, even the award itself may not be public.

Access to justice for groups affected by investment projects

A third area of concern from a sustainable development perspective relates to the implications of arbitration clauses for access to justice for third parties affected by investment projects. For instance, if the investor violates the social or environmental standards embodied in the investment contract and this harms local groups, the arbitration clause would require the host state to bring disputes against the investor before international arbitrators. Some have argued that this would effectively prevent local groups from suing the investor themselves before the domestic courts of the host or home states.

This need not be the case, however. As a matter of principle, it should be argued that arbitration clauses for disputes between the investor and the state should have no bearing on third-party rights. States cannot "sell off" the human rights of their citizens through contracts with investors, as this would violate their obligations under international human rights treaties.

Clearer wording on these issues in arbitration clauses included in investment contracts or treaties would help dispel doubts. For instance, in the case of contractual clauses, the 2003 BTC Human Rights Undertaking (see Briefing 4) explicitly clarifies that the arbitration clauses included in the contracts for the construction and operation of the BTC oil pipeline cannot be read as preventing access to the domestic courts of the host states for third parties affected by the investment project. As for treaties, the International Institute for Sustainable Development's Model Investment Agreement goes further to say that investors are also subject to civil actions in their *home* state for liability deriving from their activities abroad (see Briefing 2).

Rethinking international arbitration

International arbitration was originally conceived as a mechanism to settle commercial disputes between investors and host states. Its rules and institutions reflect this historical origin. However, recent arbitrations have frequently been associated with important sustainable development issues, such as improving access to water and sanitation for the poor.

These wider public policy implications call for a rethink of international arbitration, including by opening up proceedings to public scrutiny. The recent experience of

several civil society organisations with filing *amicus curiae* submissions is a positive step in that direction.

Space needs to be created for sustainable development issues to receive considered expert attention in those cases where there is a risk that legitimate public policy choices could be undermined by arbitral awards. ●

BOX 5.1. What can you do?

- Monitor your government's signing up to international arbitration in investment contracts and treaties, and promote public debate on the issues;
- Follow developments in international arbitration, for instance by monitoring the ICSID and other relevant web sites;
- Intervene in arbitration proceedings that raise sustainable development issues, for instance by filing third-party submissions.

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2 Particularly through "Lifting the lid on foreign investment contracts", coordinated by IIED; and "Global project finance, human rights and sustainable development", coordinated by the University of Essex in partnership with IIED.

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The briefings also draw on Dominic Ayine, Hernán Blanco, Lorenzo Cotula, Moussa Djiré, Candy Gonzalez, Nii Ashie Kotey, Shaheen Rafi Khan, Bernardo Reyes and Halina Ward, 2005, "Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development", London, IIED, Sustainable Markets Group Briefing Paper.

3 International arbitrations concerning investment disputes typically deal with disputes between an investor and a state. They are part of a broader category of arbitration ("international commercial arbitration"), which also includes disputes between private parties on sales and other commercial transactions. They must be distinguished from other forms of international arbitration, particularly those to settle disputes between states (e.g. on boundaries or other matters).

4 United Nations Commission on International Trade Law.

5 E.g. the *ELSI* case, brought by the US against Italy and decided by the International Court of Justice.

6 E.g. *Compañía de Aguas del Aconquija v Argentina*; the pending ICISD arbitrations *Biwater v Tanzania*, and *Suez, Sociedad General de Aguas de Barcelona and Vivendi v Argentina*; and the suit *Aguas del Tinari v Bolivia*, later withdrawn by the investor.

7 http://www.worldbank.org/icsid/cases/awards.htm.

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Contact: Lorenzo Cotula
IIED, 3 Endsleigh Street, London WC1H 0DD
Tel: +44 (0)131 624 7042
Fax: +44 (0)131 624 7050
Website: www.iied.org
Email: lorenzo.cotula@iied.org