

Reshaping the Investor-State Dispute Settlement System

Journeys for the 21st Century

Edited by

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Do We Need Investment Arbitration?

Christoph Schreuer

Investment protection in general and investment arbitration in particular are often portrayed as one-sided, serving the interests of investors who mostly represent big business. In actual fact, the procedural rights granted to foreign investors in the current system of investment law represent a balanced system that serves the interests of host States as well as investors.

For the investor, the risks of investing in a foreign country are considerable and quite different from those of a trader. Investment disputes, unlike trade disputes, are usually highly individualized. An investor typically must commit considerable resources before it can hope to reap the expected profits. In doing so, it makes itself dependent on the benevolence of the host State. This situation of dependence calls for strong legal protection.

After making the investment, the investor is exposed to a number of non-commercial risks at the hands of the host State. These include regime change, a change of general or sectorial economic policy, and economic or political emergencies in the host State (including public violence), to name just a few. While large multinational corporations may sometimes be in a position to pursue their claims through a variety of strategies, medium-sized and smaller investors are particularly vulnerable. For many, investment arbitration constitutes the only means of protection.

From the host State's perspective, the most obvious advantage of investment protection is improvement of its investment climate. That climate consists of a variety of elements, economic and political. The legal framework for foreign investors is an important factor in determining the investment climate, and a key component of this legal framework is the impartial and effective settlement of disputes between host States and foreign investors.

The idea of investment arbitration as an incentive or at least a safety net for foreign investment inspired the ICSID Convention. The added security thus obtained was intended to translate into increased investment, which, in turn, would stimulate economic development.

In an early publication, Aron Broches, the spiritual father and principal architect of the ICSID Convention, explained the idea underlying the drafting of the Convention. He pointed to the importance of private foreign investment

for economic development and to the role of an orderly system of dispute settlement in the following terms:

[P]rivate foreign investment [...] is of great quantitative importance as a supplement to a necessarily limited volume of public development finance....

It is beyond doubt that fear of political risks operates as a deterrent to the flow of private foreign capital to developing countries. The World Bank therefore considered it appropriate to explore whether it could make a contribution to an improvement in the investment climate, by reducing the likelihood of unresolved conflicts between host countries and investors, and in particular by doing so in a manner which would eliminate the risk of a confrontation of the host country and the national State of the investor.¹

The Convention was perceived by the directors of the World Bank as an instrument of international economic development. The link between orderly settlement of investment disputes, stimulation of private international investments and economic development is apparent from the Report of the Executive Directors on the Convention:

9. In submitting the attached Convention to governments, the Executive Directors are prompted by the desire to strengthen the partnership between countries in the cause of economic development. The creation of an institution designed to facilitate the settlement of disputes between States and foreign investors can be a major step toward promoting an atmosphere of mutual confidence and thus stimulating a larger flow of private international capital into those countries which wish to attract it.

....

12. [A]dherence to the Convention by a country would provide additional inducement and stimulate a larger flow of private international investment into its territories, which is the primary purpose of the Convention.

¹ A. Broches, *The Convention on the Settlement of Investment Disputes between States and Nationals of Other States*, 136 RECUEIL des COURS 331, 343 (1972 II) (*Convention on the Settlement of Investment Disputes*).

This sentiment is reflected in the first sentence of the ICSID Convention's Preamble, which speaks of "the need for international cooperation for economic development, and the role of private international investment therein."

In one of the early cases, an ICSID tribunal echoed the same idea:

Thus, the Convention is aimed to protect, to the same extent and with the same vigour the investor and the host State, not forgetting that to protect investments is to protect the general interest of development and of developing countries.²

At times, the effectiveness of legal guarantees for the protection of investments as a driving force for economic development has been cast into doubt. Some authors have pointed out that, on the basis of statistical data, it is impossible to prove an added flow of investment as a consequence of investment protection treaties.³ Apart from the difficulties in applying simple cause and effect models to complex situations determined by multiple factors, it is questionable whether this is the only relevant issue. The usefulness of a method for the orderly settlement of disputes cannot be measured in terms of quantifiable economic parameters alone.

Improvement of the host State's investment climate is not the only advantage of investment arbitration. A major benefit that is often overlooked is the impact on the relations between the States concerned. Diplomatic protection by the investor's State of nationality has been a frequent source of irritation and discord. In the presence of an effective system of investor-State arbitration, the host State and the investor's home State are less likely to get drawn into investment disputes. Where investment arbitration is available, these disputes are transferred from the political arena to a judicial forum especially charged with the settlement of mixed investor-State disputes. The dispute settlement process is depoliticized and subjected to objective legal criteria.

2 *Amco Asia Corporation and others v. Republic of Indonesia*, ICSID Case No. ARB/81/1, Decision on Jurisdiction, ¶ 25 (25 Sept. 1983); see Award, ¶ 249 (20 Nov. 1984); see also the references in *Československa obchodní banka, a.s. v. Slovak Republic*, ICSID Case No. ARB/97/4, Decision on Jurisdiction, ¶ 64 (24 May 1999); *Patrick Mitchell v. Democratic Republic of the Congo*, ICSID Case No. ARB/99/7, Decision on Annulment, ¶ 28 (1 Nov. 2006); *Waguïh Elie George Siag and Clorinda Vecchi v. Arab Republic of Egypt*, ICSID Case No. ARB/05/15, Decision on Jurisdiction, ¶ 38 (11 Apr. 2007); *Malaysian Historical Salvors v. Malaysia*, ICSID Case No. ARB/05/10, ¶ 66 (17 May 2007).

3 For detailed treatment see K.P. Sauvant, L.E. Sachs eds., *The Effect of Treaties on Foreign Direct Investment* (2009).

In the course of the ICSID Convention's drafting, the exclusion of diplomatic protection was explained *inter alia* in terms of the removal of the dispute from the realm of politics and diplomacy into the realm of law.⁴ In the words of Aron Broches, who chaired the preparatory meetings for the Convention:

The Convention would [...] offer a means of settling directly, on the legal plane, investment disputes between the State and the foreign investor and insulate such disputes from the realm of politics and diplomacy.⁵

Investment arbitration has drastically reduced the potential for inter-State conflict. By consenting to ICSID arbitration, a host State obtains the assurance that it will not be exposed to an international claim by the investor's home State as long as it abides by an award. In turn, the investor's home State is absolved of the inconvenience of representing its national and can conduct its foreign policy free from the embarrassment and obstruction caused by investment disputes. This aspect of investment arbitration is reflected in Article 27 of the ICSID Convention, which proscribes diplomatic protection in cases where there is consent to arbitration under the Convention.⁶

A positive side effect of investment protection that may not have been on the minds of the drafters of the relevant treaties is the introduction and promotion of principles of good governance in domestic legal systems. Investment protection treaties provide for the rule of law and its effective implementation with respect to foreign investors. The relevant standards have begun to show spill-over effects on the internal systems of the countries concerned.

Without investment arbitration, the only remedies left to a foreign investor are diplomatic protection and resort to the host State's domestic courts. From the investor's perspective, both these possibilities offer limited hope.

Diplomatic protection involves the espousal of the investor's claim by its State of nationality and the pursuit of that claim in the State's own name. It is a surrogate procedure to compensate for the traditional absence of standing

4 *Convention on the Settlement of Investment Disputes*, at 242, 273, 303, 372, 464 (Documents Concerning the Origin and the Formulation of the Convention (History of the Convention)).

5 *Id.* at 464.

6 Art 27(1): "No Contracting State shall give diplomatic protection, or bring an international claim, in respect of a dispute which one of its nationals and another Contracting State shall have consented to submit or shall have submitted to arbitration under this Convention, unless such other Contracting State shall have failed to abide by and comply with the award rendered in such dispute."

of non-State actors on the international plane. In 1934, Edwin M. Borchard described diplomatic protection in the following terms:

[T]he institution of protecting citizens abroad is a reflection [...] of a primitive form of clan organization and of an early social institution which deemed an injury to a member of the clan an injury to the clan itself, justifying collective revenge or prosecution.⁷

The drawbacks of diplomatic protection for the relations between States have been discussed above. From the investor's perspective, diplomatic protection is far less attractive than it initially appears. It requires the prior exhaustion of local remedies, a cumbersome, time-consuming and expensive procedure. In addition, diplomatic protection is discretionary: in other words, the investor's home State may but need not take up the claim. Whether the State becomes active depends on a variety of factors, including the investor's political proximity to the current government and the importance of the claim to the State. Not least, the decision whether or not to exercise diplomatic protection depends on the relations of the two States. A politically or economically weak State may find that it is not in a position to pursue a disagreement with a more powerful one. Sensitive discussions on other matters may make it imprudent for an investor's home State to open a new diplomatic front.

Even if the investor's home State starts exercising diplomatic protection, there is no guarantee that it will do so effectively. It may discontinue its efforts or agree to a reduced settlement. Even worse, it may actually waive the claim of its national. In other words, in a situation of diplomatic protection the investor loses control over its claim.

From an investor's perspective, the alternative of resorting to a host State's domestic courts is of limited attractiveness. Domestic courts are organs of the State and judges are State employees. In arbitration, the appointment of employees of one of the parties as arbitrators is taboo. There is no persuasive argument why different standards should apply to domestic courts in cases against forum States. Lack of independence and impartiality of these courts and a sense of loyalty towards local interests are recurring problems that arise for foreign investors that try to vindicate their rights before domestic courts against the forum State.

It is a sad fact that many countries lack a truly independent judiciary. In his paper "Enclaves of Justice," Jan Paulsson, relying on numerous international

7 Edwin M. Borchard, *The Protection of Citizens Abroad and Change of Original Nationality*, 43 YALE L.J. 359, 361 (1934).

reports on the state of the judiciary systems in a wide range of States, had this to say about proclamations of the rule of law: “This vision is an illusion. Worse, it is a fraud.” He asks rhetorically: “What good is it, if judges are paid or intimidated by the powerful, or if—less dramatically but perhaps more insidiously—the courts simply don’t work?” He reaches the depressing conclusion that “it would be preposterous to imagine that even half of the world’s population lives in countries that provide decent justice” and “[t]he rule of law is pure illusion for most of our fellow travellers on this planet.”⁸

Even if an investor is optimistic enough to believe that this is all a bit exaggerated, what remains is enough to destroy realistic hope of finding justice in domestic courts in foreign investment cases as a general proposition. The risks for a foreign investor are even higher than for the ordinary citizen seeking justice. In many cases, the sums in dispute are high, the publicity is extensive, national loyalties abound and the resulting moral pressure on courts is considerable. A number of recent investment cases corroborate the bleak picture of domestic courts as guardians of investor rights.

The phenomenon of judicial loyalty to the forum State is well illustrated by *Deutsche Bank v. Sri Lanka*.⁹ The case involved a hedging agreement between the Ceylon Petroleum Corporation (CPC) and Deutsche Bank (DB), which led to an obligation of CPC to pay sums to DB. The Supreme Court of Sri Lanka, in a brief judgment rendered less than 48 hours after receiving a petition, ordered that all payments be suspended. The ICSID tribunal found that this far-reaching order, issued without proper examination and without giving the banks an opportunity to respond, constituted a breach of the fair and equitable treatment standard.¹⁰ It reached this finding in part on the basis of a public statement by Sri Lanka’s Chief Justice, who had been quite candid about the court’s motives:

[T]he Government was forced to comply with the hedging agreements. We will stop that on a judicial order, just pass on to benefit to the people. The Government said you stop the hedging arrangements we won’t pass on the benefit.¹¹

Where, as is often the case, an alleged violation of investor rights is a consequence of domestic legislation, domestic courts are usually powerless

8 Jan Paulsson, *Enclaves of Justice*, 4 Transnational Dispute Management, issue 5 (Sept. 2007).

9 *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*, ICSID Case No. ARB/09/2, Award (31 Oct. 2012).

10 *Id.*, ¶ 478.

11 *Id.*, ¶ 479.

to provide a remedy. Two decisions rendered in Italian bondholders' cases against Argentina illustrate the point. The BIT between Argentina and Italy requires claimants to pursue their rights before domestic courts for a period of 18 months before going to arbitration. The Tribunals decided that in view of legislation passed by Argentina that forbade payment to the claimants, any pursuit of the claim in the domestic courts was futile. The Tribunal in *Abaclat et al. v. Argentina*¹² said:

In the light of the Emergency Law and other relevant laws and decrees, which prohibited any kind of payment of compensation to Claimants, the Tribunal finds that Argentina was not in a position to adequately address the present dispute within the framework of its domestic legal system.¹³

In *Ambiente Ufficio v. Argentina*,¹⁴ the Tribunal's conclusion was similar:

Given the jurisprudence of the Supreme Court of Argentina and in the light of the circumstances prevailing in the present case, the Tribunal concludes that having recourse to the Argentine domestic courts and eventually to the Supreme Court would not have offered Claimants a reasonable possibility to obtain effective redress from the local courts and would have accordingly been futile.¹⁵

In some cases, the issue is endemic inefficiency and delay. In *Urbaser v. Argentina*,¹⁶ the applicable BIT also required the investor first to pursue its claim in the domestic courts for 18 months before going to arbitration. The Tribunal examined the question whether Argentine courts were capable of handling disputes of this kind in 18 months. It relied on a statistical study by the office of Argentina's Attorney General that demonstrated that the average time for a ruling on the merits was six years and one month and that in none of the cases considered was a decision made within 18 months.¹⁷ The Tribunal

12 *Abaclat and others v. Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction (4 Aug. 2011).

13 *Id.*, ¶ 588.

14 *Ambiente Ufficio S.p.A. and others v. Argentine Republic*, ICSID Case No. ARB/08/9, Decision on Jurisdiction and Admissibility (8 Feb. 2013).

15 *Id.*, ¶ 620.

16 *Urbaser S.A. and Consorcio de Aguas Bilbao Bizkaia, Bilbao Biskaia Ur Partzuergoa v. Argentine Republic*, ICSID Case No. ARB/07/26, Decision on Jurisdiction (19 Dec. 2012).

17 *Id.*, ¶ 196.

concluded that an investor-State dispute before the courts of Argentina would far exceed the 18 months fixed in the BIT and concluded: “A proceeding that can in no reasonable way be expected to reach that target is useless and unfair to the investor.”¹⁸

*White Industries v. India*¹⁹ involved a delay in the courts of India in set-aside and enforcement proceedings relating to an arbitral award under the New York Convention. The Tribunal applied a treaty provision in which the parties had undertaken to provide effective means of asserting claims and enforcing rights. The Tribunal diagnosed a breach of that standard:

[T]he Tribunal has no difficulty in concluding the Indian judicial system’s inability to deal with White’s jurisdictional claim in over nine years, and the Supreme Court’s inability to hear White’s jurisdictional appeal for over five years amount [...] to undue delay and constitute [...] a breach of India’s voluntarily assumed obligation of providing White with ‘effective means’ of asserting claims and enforcing rights.²⁰

In some cases, the alleged violation of investor rights is the direct consequence of acts of the judiciary. Typical examples are allegations of denial of justice, judicial expropriations and other complaints directed at domestic courts. In these cases, it is not realistic for investors to seek a remedy in these same courts.

In *Saipem v. Bangladesh*,²¹ the Tribunal found that the courts, including the Supreme Court, had expropriated the claimants’ contract rights reflected in an ICC award by nullifying that award without good cause. The Tribunal found that the Bangladeshi courts had abused their supervisory jurisdiction:

The Tribunal is of the opinion that the Bangladeshi courts exercised their supervisory jurisdiction for an end which was different from that for which it was instituted and thus violated the internationally accepted principle of prohibition of abuse of rights.²²

18 *Id.*, ¶ 202.

19 *White Indus. Australia Limited v. Republic of India*, UNCITRAL, Final Award (30 Nov. 2011).

20 *Id.*, ¶ 11.4.19.

21 *Saipem S.p.A. v. People’s Republic of Bangladesh*, ICSID Case No. ARB/05/7, Award (30 June 2009).

22 *Id.*, ¶ 161.

In *Sistem Mühendislik v. Kyrgyz Republic*,²³ the claimant was wrongfully deprived of ownership rights by decision of the domestic courts. The Tribunal said:

[T]he Claimant lost control of the hotel as a matter of fact and, by virtue of the decision of the Kyrgyz court on June 27, 2005, the Claimant was deprived of all of the rights in the hotel²⁴ [...] the Claimant's investment in the hotel was expropriated as of June 27, 2005.²⁵

In *ATA v. Jordan*,²⁶ the Tribunal found that the extinguishment of the claimant's right to arbitrate was contrary to the Turkey-Jordan BIT. That extinguishment had been brought about by the Jordanian courts through the retroactive application of Jordanian law.

Other cases do not illustrate wrongdoing on the part of domestic courts but their lack of effectiveness within the host State's domestic system. *Siag v. Egypt*²⁷ involved the seizure of the claimant's tourism project in Sinai through a series of actions by Egyptian authorities. The claimant had obtained no fewer than eight rulings by Egyptian courts in his favor but these had been consistently ignored by the executive. The Tribunal found that Egypt's failure to honour the decisions of its own courts constituted a denial of justice and a violation of the fair and equitable treatment standard:

The Tribunal considers that Egypt's submission that it respected the rulings of its courts is wholly unsupported by the evidence.

The Tribunal accordingly finds that Egypt's actions failed to afford the Claimants due process of law. The Tribunal further considers that the failure to provide due process constituted an egregious denial of justice to Claimants, and a contravention of [...] the BIT, in that Egypt failed to ensure the fair and equitable treatment of Claimant's investment.²⁸

23 *Sistem Mühendislik Insaat Sanayi ve Ticaret A.S. v. Kyrgyz Republic*, ICSID Case No. ARB(AF)/06/1, Award (9 Sept. 2009).

24 *Id.*, ¶ 122.

25 *Id.*, ¶ 128.

26 *ATA Construction, Industrial and Trading Company v. Hashemite Kingdom of Jordan*, ICSID Case No. ARB/08/2, Award (18 May 2010).

27 *Waguih Elie George Siag and Clorinda Vecchi v. Arab Republic of Egypt*, ICSID Case No. ARB/05/15, Award (1 June 2009).

28 *Id.*, ¶¶ 454, 455.

In *Meerapfel v. Central African Republic*,²⁹ the respondent justified its failure to abide by decisions of its domestic courts by discrediting these courts and casting doubt on their integrity and transparency. The Tribunal rejected these allegations for lack of evidence and held that there was no justification for the repeated refusal of the Central African Republic to implement the decisions of its courts to the detriment of the investor:

327. Il est important de noter qu'à divers moments, les autorités locales de RCA n'ont pas respecté les jugements des tribunaux centrafricains portant sur les affaires relatives au présent litige, notamment les décisions favorables aux intérêts de la Demanderesse et de [la société A].

[...]

328. Au regard de certains cas de non respect des décisions judiciaires, la Défenderesse soutient que sa conduite était justifiée en remettant en cause l'intégrité et la transparence des procédures des cours ou des tribunaux concernés. Toutefois, elle n'a produit aucune preuve concrète à l'appui de ces allégations. Le Tribunal estime qu'il n'existe pas de justification rationnelle et appropriée au refus répété de la Défenderesse de ne pas exécuter les décisions prononcées par ses propres tribunaux au détriment des droits et intérêts de la Demanderesse et de sa filiale locale.³⁰

These are just a few random examples from recent practice. They illustrate the fact that domestic courts cannot be relied upon to provide a realistic remedy to foreign investors. In many countries, there is no independent judiciary. Even where courts are independent in principle, their decisions are often influenced by national loyalties. When measures adverse to foreign investors are taken by way of domestic legislation, the courts are usually unable to be of assistance to foreign investors even if they are disposed to do so. Where the source of the foreign investor's complaints lies in the activity or inactivity of the courts, it is unrealistic to expect relief from these same courts. Some countries have judiciaries that function in principle, but are so slow and inefficient as to border on a denial of justice. In other countries the courts may find in favor of foreign investors but their decisions are ignored by the administration.

29 *M. Meerapfel Söhne AG v. Central African Republic*, ICSID Case No. ARB/07/10, Award (12 May 2011).

30 *Id.*, ¶¶ 327, 328.

These examples also demonstrate that any reintroduction of a requirement to exhaust local remedies would be a retrograde step. That requirement, developed under the regime of diplomatic protection, was not carried over to investment arbitration for good reasons. The aim of investment arbitration was to get away from the vagaries of proceeding through domestic courts. A requirement to exhaust local remedies in investment arbitration would add considerable cost, long delays and an additional element of uncertainty to the process. The primary victims of such a step would be small- and medium-sized investors.

In sum, at present there is no substitute for investment arbitration. Despite its undeniable weaknesses, it is currently the only functioning system for the orderly settlement of the numerous disputes arising from foreign investments.