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ISDS Legitimacy Crisis: Is a Procedural Reform Enough?

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Abstract

In light of the legitimacy crisis of the Investor-State Dispute Settlement (ISDS) mechanism, the Third Working Group (WGIII) of the United Nations Commission on International Trade Law (UNCITRAL) initiated its most ambitious project on the reform of the mechanism. Although the WGIII is expected to take ten years to finish the project, there is consensus that the procedural reform should not conclude the ISDS reform project. This article offers reasons for why procedural reform is not enough for the success of ISDS and provides several considerations for substantive reforms towards a sustainable ISDS. An overview of the ISDS history would explain that the legitimacy crisis of ISDS is not only procedural, but also substantive. The idea of substantive reforms toward a sustainable ISDS is not new, but the attempts are fragmented. A study of existing solutions, not only in the field of international investment law, but also in other fields of international law, will contribute to the discussion on how to reform ISDS substantively.

I. Introduction: ISDS in the best and worst of times

"We cannot solve our problems with the same thinking we used when we created them"

Albert Einstein

"It was the best of times, it was the worst of times."

Teresa Cheng in reference to Charles Dickens' A Tale of Two Cities to describe the *status quo* of Investor-State Dispute Settlement (ISDS).[1]

ISDS is a mechanism of dispute settlement allowing foreign investors to initiate legal proceedings against host States, but not *vice versa*. Most ISDS cases are brought under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention). Another framework for Investor-State Arbitration (ISA) is the ISDS option usually provided in international investment agreements (IIAs). There are more than 3000 IIAs, and approximately 95% of them include ISDS.[2]

On the one hand, the mechanism is going through the best of times. As of the 31st of December 2022, a total of 1,257 cases of ISA had been recorded.[3] Between 2015 and 2021, more than 70 new cases had been filed each year.[4] As of May 2020, the mean damages claimed by

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[1] Teresa Cheng, 'The Search for Order within Chaos in the Evolution of ISDS' in Meg Kinnear and Campbell McLachlan (eds) *ICSID Review* 35(1) (OUP 2020), 1.

[2] UNCTAD, 'Mapping of IIA Content' <https://investmentpolicy.unctad.org/international-investment-agreements/iia-mapping> accessed 9 January 2024.

[3] UNCTAD, 'Total number of known investment treaty cases rises to 1,257' (19 April 2023) <https://investmentpolicy.unctad.org/news/hub/1717/20230419-total-number-of-known-investment-treaty-cases-rises-to-1-257> accessed 21 October 2023.

[4] UNCTAD, 'IIA Issues Note - Fact Sheet on Investor-State Dispute Settlement Cases in 2018' (May 2019) <https://unctad.org/system/files/official-document/diaepcbinf2019d4_en.pdf> accessed 21 October 2023.

investors (excluding *Yukos* cases[5]) amount to US$1.16 billion.[6] To some extent, this shows that investors opt for ISDS when the amount in dispute is considerable.

On the other hand, the mechanism is going through the worst of times. Since the early 2010s[7], ISDS has been facing increased criticism.[8] These critiques can be divided in two categories: procedural and substantive. Procedurally, ISDS is seen to promote the unscrutinised power of some individuals[9], to place States in a passive role by only allowing investors to sue the host State, to aggravate the existing fragmentation of international law.[10] Substantively, some scholars argue that the ISDS creates reverse discrimination towards national investors[11], ignores human rights and environmental protection[12], "undermines rule of law and democracy",[13] and leads to regulatory chill.[14]

There is consequently a "growing consensus on the need for reform" of ISDS.[15] Some scholars even advocate for a *tabula rasa* in international investment law.[16] As a means of answering to these critiques, the Third Working Group (WGIII) of the United Nations Commission on International Trade Law (UNCITRAL) has been working on the reform of the ISDS since 2017. Its work focuses exclusively on procedural reform,[17] including the elaboration of a code of

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[5] *Hulley Enterprises Limited (Cyprus) v. The Russian Federation*, UNCITRAL, PCA Case. No. 2005-03/AA226 (Final Award, 18 July 2014, awarding the investor US$ 39,971,834,360 out of US$ 93.229 billion of damages claimed (paras. 110 (3), 1888 (f))). *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL, PCA Case No. 2005-04/AA227, Final Award, 18 July 2014 (awarding the investor US$ 1,846,000,687 out of US$ 4.666 billion of damages claimed (paras. 110 (3), 1888 (f))). *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*, UNCITRAL, PCA Case No. 2005-05/AA228, Final Award, 18 July 2014 (awarding the investor US$ 8,203,032,751 out of US$ 16.279 billion of damages claimed (paras. 110 (3), 1888 (f))).

[6] Matthew Hodgson, Yarik Kryvoi, Daniel Hrcka, *2021 Empirical Study: Costs, Damages and Duration in Investor-State Arbitration* (2021) British Institute of International and Comparative Law, Allen & Overy, 28 <https://www.biicl.org/documents/136_isds-costs-damages-duration_june_2021.pdf> accessed 27 October 2023.

[7] Vera Weghmann, David Hall, 'The unsustainable political economy of investor–state dispute settlement mechanisms' (2021) 87(3) IRAS,488.

[8] UNCITRAL, Possible future work in the field of dispute settlement: Reforms of investor State dispute settlement (ISDS) Note by the Secretariat, Fiftieth session, Vienna, 3-21 July 2017, A/CN.9/917, para. 11. <https://documents-dds-ny.un.org/doc/UNDOC/GEN/V17/023/69/PDF/V1702369.pdf?OpenElement>

[9] Sergio Puig, 'Social Capital in the Arbitration Market' (2014) 25(2) EJIL, 387.

[10] Stephan W. Schill, 'Authority, Legitimacy, and Fragmentation in the (Envisaged) Dispute Settlement Disciplines' in Mega-Regionals *in* S. Griller, W. Obwexer, & E. Vranes (Eds.), *Mega-Regional Trade Agreements: CETA, TTIP, and TiSA: New Orientations for EU External Economic Relations* (International Economic Law Series, OUP 2017), 111.

[11] Mathias Baudena, 'Investor-State Dispute Settlement: Understanding the System's Legitimacy Crisis in Constitutional Terms' (*LSE Law Review Blog*, 18 February 2021) <https://blog.lselawreview.com/2021/02/investor-state-dispute-settlement> accessed 23 September 2023.
Contra: Christian Riffel, 'Does Investor-State Dispute Settlement Discriminate Against Nationals?' (2020) 21(2) German Law Journal, 197.

[12] Special Rapporteur on human rights and the environment, 'Call for inputs: "Should the interests of foreign investors trump the human right to a clean, healthy and sustainable environment?"' (*OHCHR*, 15 June 2023) <https://www.ohchr.org/en/calls-for-input/2023/call-inputs-should-interests-foreign-investors-trump-human-right-clean-healthy> accessed 23 September 2023.

[13] OHCHR, 'Investor-State dispute settlement undermines rule of law and democracy, UN expert tells Council of Europe' (*OHCHR*, 19 April 2016) <https://www.ohchr.org/en/press-releases/2016/04/investor-state-dispute-settlement-undermines-rule-law-and-democracy-un> accessed 23 September 2023.

[14] Kyla Tienhaara, 'Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement' (2018) 7(2) Transnational Environmental Law, 229.

[15] Stephan W. Schill, 'Reforming Investor-State Dispute Settlement (ISDS): Conceptual Framework and Options for the Way Forward' (E15Initiative) (2015) International Centre for Trade and Sustainable Development/World Economic Forum. <https://pure.uva.nl/ws/files/2512304/163092_E15_Investment_Schill_FINAL.pdf> accessed 24 September 2023.

[16] Muthucumaraswamy Sornarajah, 'Chapter 8: Resistance and change in international investment law' in *Resistance and Change in the International Law on Foreign Investment* (CUP 2015), p. 408.

[17] UNCITRAL, A/CN.9/917 (n 8) para. 14.

conduct, the investment mediation and dispute prevention, the establishment of a multilateral advisory centre, the establishment of a multilateral permanent investment court, and the elaboration of an appellate mechanism.[18]

Inarguably, it is an ambitious project. The WGIII has spent the past six years studying different reform elements, and the project is expected to be completed in 2026.[19] However, "we cannot solve our problems with the same thinking we used when we created them."[20] Kelsey *et al.* suggest that the project is "unduly narrow" as it ignores substantive matters and concentrates on only three categories of procedural concerns, namely "consistency, coherence, predictability and correctness of arbitral decisions", "arbitrators and decision-makers" and "cost and duration of ISDS cases".[21] Alvarez also argues that "one cannot stabilise and legitimise a legal regime that many believe, rightly or wrongly, should not exist simply by trying to improve how it is enforced".[22]

This article will focus on demonstrating why a purely procedural reform is not enough for the success of ISDS, leaving different necessary-but-not-yet-addressed procedural reforms for another discussion.

For this purpose, Section II will provide the necessary historical background of ISDS for the discussion of the legitimacy crisis that the ISDS is currently facing in Section III. Section IV will address common misunderstandings of this legitimacy crisis, and answer therefore why a procedural reform envisaged by WGIII is not enough. Section V tries to point out several considerations on substantive reforms towards a sustainable ISDS. The article will conclude with section VI.

II. From the problematic inter-State dispute settlement to the controversial ISDS

International law was constructed to regulate the relations between nations and nations.[23] Under this definition, there was no place for any entity other than the States. Investors, in order to protect their interests in the host State, would have asked for diplomatic protection from their States of origin.[24] Diplomatic protection, discretionally granted by the State of origin,[25] may take the forms of negotiation, and inter-State adjudication, should the negotiation prove to be unfruitful. Before its general prohibition, the State of origin had an alternative, which was the use of force or the threat of force, also referred to as "gunboat diplomacy".

The weaknesses of this inter-State dispute settlement were quickly identified. Firstly, an investment dispute involving a foreign investor and the host State is not equivalent to a dispute involving two States. By initiating an inter-State dispute, the State of origin politicises an

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[18] UNCITRAL, Working Group III: Investor-State Dispute Settlement Reform, <https://uncitral.un.org/en/working_groups/3/investor-state> accessed 24 September 2023.

[19] Anthea Roberts and Taylor St John, 'UNCITRAL and ISDS Reform: What to Expect When You're Expecting' (*EJIL: Talk!*, October 5, 2022) <https://www.ejiltalk.org/uncitral-and-isds-reform-what-to-expect-when-youre-expecting/> accessed 24 September 2023.

[20] *Russel-Einstein Manifesto*, 9 July 1955, London.

[21] Jane Kelsey, David Schneiderman, Gus van Harten, 'Phase 2 of the UNCITRAL ISDS Review: Why "other matters" really matter' (*IISD, Investment Treaty News*, 26 March 2019) <https://www.iisd.org/itn/en/2019/03/26/phase-2-of-the-uncitral-isds-review-why-other-matters-really-matter-jane-kelsey-david-schneiderman-gus-van-harten/> accessed 24 September 2023.

[22] José E Alvarez, 'ISDS Reform: The Long View' (2021) 36(2) *ICSID Review*, 254.

[23] Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation*, (Batoche Books Kitchener 2000), 10.

[24] *Mavrommatis Palestine Concessions case (Greek v United Kingdom)*, Judgment, 30 August 1924, PCIJ Series A, No 2, 12.

[25] *Barcelona Traction, Light and Power Co., Ltd. (Belgium v Spain)*, Judgment, 5 February 1970, ICJ Reports (1970) 3, para. 79.

investment dispute and takes the risk of straining international relations.[26] Secondly, some countries were particularly exposed to abuses of diplomatic protection and vulnerable to armed intervention[27], as it was proven by the case of many Latin American countries in the 1800s.[28]

In the context of promoting peaceful dispute settlement after World War II, the ICSID Convention introduced the ISDS in 1965. In 1969, the same mechanism appeared in the BIT between Italy and Chad. The first ISDS case is, however, the 1987 arbitration between AAPL (a Hong Kong corporation) and Sri Lanka[29], instituted on the basis of the UK–Sri Lanka BIT, extended to Hong Kong in 1981. Since then, ISDS has become the preferred dispute settlement mechanism of foreign investors.

Some argue that the mechanism was born to resolve investment disputes in a peaceful and apolitical manner.[30] Others posit that the creation of ISDS was motivated by a problematic mindset, to protect the economic interests of foreign investors from developed countries from the public interests of the host State, which was usually a developing country.[31] This suggestion was based on the fact that the first IIAs with an ISDS option were concluded between developed and developing countries respectively, and that developing countries are the main respondent to all ISDS cases.[32] This would imply that the mechanism is profoundly unbalanced. On the one hand, developing countries should accept the ISDS option because it is believed that IIAs and their investment protection mechanism, including ISDS, contribute to the increase in foreign direct investment (FDI), and thus to the economic development of the host State.[33] On the other hand, developed countries, leading in foreign direct investment, play an important role in drafting this mechanism. This advantageous position is illustrated by the fact that model BITs are usually drafted by developed economies, and followed by developing contracting parties.[34] Consequently, an unbalanced mechanism was created.

III. Legitimacy crisis of ISDS

Since ISDS was created to protect the private interests of investors from developed countries from the public interest of the host State, disputes over the mechanism existed in the Global South from its beginning. IIAs with ISDS option were seen as harmless to developed countries. However, the case *of Vattenfall AB and others v. Federal Republic of Germany* proved the contrary. Vattenfall is a Swedish power company. Its construction of the powerplant in the City

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[26] Rudolf Dolzer, Ursula Kriebaum, and Christoph Schreuer, Principles of International Investment Law, (3rd Edn, OUP 2022),335.

[27] Rodrigo Polanco, 'The Age of Diplomatic Protection of Foreign Investors' in *The Return of the Home State to Investor-State Disputes: Bringing Back Diplomatic Protection?*, Cambridge International Trade and Economic Law (CUP 2019), 11.

[28] Christopher K. Dalrymple, 'Politics and Foreign Investment: The Multilateral Investment Guarantee and the Calvo Clause' (1996) 29(1) Cornell Int'l L., 164.

[29] *Asian Agricultural Products Ltd v Republic of Sri Lanka* (*AAPL v Sri Lanka*), ICSID Case No ARB/87/3, Award (27 June 1990).

[30] 'Report of the Executive Directors on the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States' (*International Bank for Reconstruction and Development*, 18 March 1965), para. 9.

[31] Puig (2014) (n 9) p. 395.

[32] Gus Van Harten, 'Origins of ISDS Treaties', *The Trouble with Foreign Investor Protection* (Oxford, 2020), 33; UNCTAD (n 2).

[33] Deborah L. Swenson, 'Why Do Developing Countries Sign BITs?', *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (New York, 2009); Arghyrios Fatouros, 'International Economic Development and The Illusion of Legal Certainty', *Proceedings of the American Society of International Law at Its Annual Meeting (1921-1969)*, vol. 57, 1963, pp. 117; Hallward-Driemeier, Mary, 'Do Bilateral Investment Treaties Attract FDI? Only a Bit … and They Could Bite', *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (New York, 2009), 355.

[34] Dolzer, Kriebaum, and Schreuer (n 26) p. 17.

of Hamburg was allowed by the Christian Democratic Union (CDU) in 2007. The CDU was subsequently defeated by the Green Party in the following election in Hamburg. The Green Party imposed new restrictions on the project, damaging Vattenfall's profits. Estimating that its right to investment protection under the Energy Charter Treaty to which Sweden and Germany are both parties was violated, the Swedish company initiated proceedings against Germany on the basis of this treaty. It was the first time that a developed country was respondent to an ISDS claim, and therefore motivated speculation on how ISDS may influence policy-making.[35]

These analyses usually conclude that independent of the nationality of the investor and the host State, there is an imbalance between private and public interest in ISDS.

Firstly, without a coherent jurisprudence, the ISDS mechanism cannot guarantee that the private interest of foreign investors is not prioritised over the right of the host State to freely regulate. Except for some modern international investment agreements (IIAs)which establish a permanent investment court[36], treaty-based international investment tribunals are generally created *ad hoc*. The arbitral awards of these *ad hoc* tribunals in relation to the ISDS mechanism are thus binding on the disputing parties in a specific dispute only.[37] Without jurisprudence[38], and given the 3000 IIAs actually in force, different interpretations of similar clauses are likely. For example, as explained above, the *raison d'être* of the ISDS mechanism is the preservation of the economic interests of foreign investors. However, in recent years, arbitral panels consider more frequently and more seriously the public interests of the host states, such as environmental protection, human rights, labour rights, etc. This does not mean that this is a consistent trend. The *ad hoc* tribunals and the lack of jurisprudence prevent consolidation of this trend.

Secondly, the inconsistency of ISDS implementation provokes regulatory chill[39] in some states when failing to take into consideration non-economic interests of the host State.[40] It should be clarified that the regulatory-chill anecdote is not the abandonment of public policy. Instead, governments adopt a "wait-and-see attitude" to avoid litigation.[41]

Thirdly, it is also said that arbitrators lack sufficient legitimacy to hold the power to determine the balance between public and private interests without having their decisions appealed.[42] Some scholars question the lack of diversity in international arbitral proceedings and describe ISA as a "white, male game".[43] However, it is likely that this criticism should not only be directed against the ISA, but also international courts and tribunals as a whole.[44] Others criticise

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[35] Weghmann, Hall (2021) (n 7); UNCITRAL, A/CN.9/917 (n 8) para. 11.
[36] See, *inter alia*, Comprehensive Economic and Trade Agreement (CETA), Chapter Twenty-nine, Section C, esp. art. 29.7-29.8; EU–Vietnam Free Trade Agreement (EVFTA), Chapter Fifteen, Section C, esp. art. 15.7 and 15.23.
[37] See, inter alia, Art. 15(6) Malaysia - Netherlands BIT (1971) stipulates that "Such decisions shall be binding", Art. 13(4) Egypt - Japan BIT (1977) stipulates that "Such decisions shall be final and binding", Art. 32(6) Chile - Hong Kong, China SAR BIT (2016) stipulates that "An award made by a tribunal shall have no binding force except between the disputing parties and in respect of the particular case."
[38] Art. 53(1), ICSID Convention, AES v Argentina, Decision on Jurisdiction, 26 April 2005, para. 23, Dolzer, Kriebaum, and Schreuer (n 26), pp. 45-46.
[39] Tienhaara (2018) (n 14).
[40] Alvarez (2021) (n 22), p. 254.
[41] Carolina Moehlecke, 'The chilling effect of international investment disputes: limited challenges to state sovereignty', (2020) 64(1) *International Studies Quarterly*, 3
[42] (n 36)
[43] F. Peter Phillips, 'ADR Continental Drift: It Remains a White, Male Game' (*The Nat'l LJ*, 27 Nov. 2006) <https://businessconflictmanagement.com/pdf/BCMpress_08.pdf> accessed 23 September 2023.
[44] Nienke Grossman, 'Sex Representation on the Bench and the Legitimacy of International Criminal Court' (2011) 11(3) Int'l Criminal L Rev, 643.

the independence and impartiality of arbitrators when they are appointed by parties.[45] They may even envisage the risk of re-politicisation of ISDS[46] when arbitrators acquire a reputation (e.g. of being "conservative", "progressive", or "independent") to ensure future appointment.[47]

IV. Why are structural reforms of ISDS not enough?

Recent developments in the WGIII's work have brought into question its exclusive focus on procedural issue (A) and reignited discussions on a substantive reform (B).

A. WGIII's focus on procedural reforms questioned by the cross-cutting issues

Since 2017, the WGIII has been working on the reform of ISDS. The work focuses exclusively on procedural matters, leaving substantive matters to future projects.[48] Reforms are suggested on the basis of the existing UNCITRAL's ISDS regime,[49] which mainly deals with procedural issues, such as the composition of arbitral tribunals (section II), arbitral proceedings (section III), and awards (section IV). Only a few provisions in the document touch on substantive matters, but in a very abstract way (cf. Articles 29(1), 35 UNCITRAL Arbitration Rules, 2021).

This focus is explained by the "desirability and feasibility"[50] of the project. Work on substantive matters usually involves sensitive questions relating to public interests, human rights, environmental protections, etc.[51], and is therefore less likely to reach a consensus than work on procedural matters.[52] In order to secure the success of the project, the WGIII chose the "phasing approach" by discussing the procedural reform before starting a "different and more complicated process" on "which and how substantive protection standards should be reformed".[53]

However, recent developments in the WGIII's discussion relating to damages, compensation, and other cross-cutting issues,[54] show that the strict distinction between procedural and substantive matters may not always be appropriate. Although these cross-cutting issues have procedural aspects, they also present substantive ones. The exclusive focus on procedural matters allows States who do not support discussions in some sensitive matters to argue that these discussions fall outside the mandate of the WGIII.[55]

As a consequence, one should not believe that procedural reforms alone will solve the legitimacy crisis of ISDS. Procedural changes, especially those dealing with the appointment of

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[45] James Devaney, 'An Independent Panel for the Scrutiny of Investment Arbitrators: an Idea Whose Time Has Come?' (2020) 18(3) *The Law & Practice of International Courts and Tribunals* 369.
Contra: Catherine A. Rogers, 'Reconceptualizing the Party-Appointed Arbitrator and the Meaning of Impartiality', *Bocconi Legal Studies Research Paper No. 4154481, Harvard Int'l L.J.* (Forthcoming 2023).
[46] Fernando Dias Simões, 'Can Investment Dispute Settlement Ever Be Depoliticized?' (2021) 4(2) *Cardozo International and Comparative Law Review*, The Chinese University of Hong Kong Faculty of Law Research Paper No. 2021-20,509.
[47] Puig (2014) (n 9) p. 400.
[48] UNCITRAL, A/CN.9/917, (n 8), para. 14.
[49] ibid, para. 15.
[50] UNCITRAL, Report of the United Nations Commission on International Trade Law, Fiftieth session (3-21 July 2017), A.72/17, para. 244.
[51] UNCITRAL, A/CN.9/917, (n 8), para. 14.
[52] UNCITRAL (n 49), para. 257.
[53] UNCITRAL, A/CN.9/917, (n 8), para. 14.
[54] UNCITRAL, Report of Working Group III (Investor-State Dispute Settlement Reform) on the work of its forty-third session (Vienna, 5–16 September 2022), A/CN.9/1124, paras. 89-104
[55] Güneş Ünüvar, 'The Mandate Conundrum: Reflections on the 46th Session of the UNCITRAL Working Group III on ISDS Reform' (*EJIL: Talk!*, November 21, 2023) <https://www.ejiltalk.org/the-mandate-conundrum-reflections-on-the-46th-session-of-the-uncitral-working-group-iii-on-isds-reform/> accessed 16 January 2024.

arbitrators, establishing a multilateral investment court (MIC), would only answer many superficial critiques. An exclusive focus on procedural reform will prove ineffective on certain topics, such as damages and compensation, and from a long-term perspective.

B. The need for a substantive reform

Procedural reforms should be understood as the premises to substantive reforms for two main reasons. On the one hand, the core concerns should not be purely procedural but also substantive. On the other hand, as argued by South Africa, "[p]romoting and attracting investment should not be an end in itself, but a step towards realising the broader objectives of the SGDs [sustainable development goals] and the human rights obligations".[56]

1. The core concerns lay in substantive matters

If ISDS awards can be criticised for incoherence, it is not only due to the fragmentation of IIAs and arbitral tribunals. The root cause may come from the lack of necessary substantive standards in IIAs. As has been developed throughout this article, the main legitimacy crisis of the ISDS stems from the lack of balance between private interest (economic interest) and public interest (social interest).

Procedural reforms consist of establishing a permanent investment court, elaborating an appeal mechanism, and regulating the costs and duration of an arbitration. These reforms can *prima facie* respond to critiques about the imbalance between private and public interests. However, these changes cannot ensure the balance in the long term.

Firstly, even with a system of jurisprudence, the lack of coherent and clear provisions on how a State should promulgate new policies prevents the arbitrators from protecting public interest when the standard of protection of public interest in the host State at the moment of the investment is relatively low. Data on arbitration in the Latin Americas shows a clear skew (70% in favour of the result benefiting foreign investors, 30% benefiting the States),[57] whilst on the global scale, among 1257 recorded treaty-based ISDS cases, 327 cases (36,7%) were decided in favour of the States, compared with 249 cases (28%) which were awarded in favour of investors.[58] Were the problem to come from a lack of jurisprudence, the biased result would be observed also on the global scale. Furthermore, despite multiple efforts to preserve the environment, the standard of protection in Latin America and the Caribbean is criticised for being unambitious.[59] The problem may not exclusively come from the lack of jurisprudence, but also from the ambiguous right to regulate of the host State.

Secondly, a permanent investment court and an appeal mechanism cannot prevent the excessive expansion of an ambiguous investment protection standard, to the detriment of the host State's regulatory power. For example, it was, for a long time, ambiguous what was incorporated

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[56] South Africa, 'Possible reform of Investor-State dispute settlement (ISDS), Submission from the Government of South Africa', A/CN.9/WG.III/WP.176, para. 16.

[57] Impacts of investment arbitration against Latin America and the Caribbean in Cecilia Olivet, Bettina Müller and Luciana Ghiotto, *ISDS in Numbers*, December 2017, Transnational Institute <https://www.tni.org/files/publication-downloads/isds_en_numerosen2017.pdf> accessed 23 September 2023.

[58] Investment Dispute Settlement Navigator <https://investmentpolicy.unctad.org/investment-dispute-settlement> accessed 23 September 2023.

[59] OECD, 'Environment at a Glance in Latin America and the Caribbean' (OECD, 4 July 2023) <https://www.oecd.org/publication/environment-at-a-glance-lac/chapter-d1e5791#heading-d1e5792> accessed 18 January 2024.

in the fair and equitable treatment (FET) standard.[60] Were the discussion to be solved simply by a permanent court, scholars would not write a myriad of papers[61] explaining the components of FET. The need for a clear and unambiguous standard is widely recognised in domestic legal system[62], and even in some fields of international law.[63] It is thus hard to see how this point is underestimated in international investment law.

2. Substantive reform itself is desirable from different perspectives

Firstly, there is a common misconception that IIAs and ISDS will increase FDI since they increase legal certainty – a pre-condition for foreign investment.[64] However, statistics suggest that such is not always true.[65] While China is the main receiver of FDI from the USA, there is no BIT between these two countries.[66] Also, Japan – one of the big investors in developing Asia[67], has few BITs with countries in this region.[68] In other words, whether IIAs and ISDS are reformed or not, there are few chances that it would hugely impact FDI of a country.

More importantly, foreign investors may also be interested in substantive reform, even when it elaborates standards of public interest protection. Usually, it is argued that economic interest and public interest cannot go hand in hand. However, the practice proves that investors may gain economic interests when taking public interest into consideration.[69]

Finally, focusing on economic interest is not the only way to promote economic development. Numerous studies demonstrate the correlation between sustainable development and economic development.[70] For example, cheap labour or lax environmental policy may attract

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[60] *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award, 12 May 2005, para. 273; Dolzer, Kriebaum, and Schreuer (n 26), 186

[61] Ioana Tudor, The Fair and Equitable Treatment Standard in International Foreign Investment Law, OUP 2008; Dolzer, Kriebaum, and Schreuer (n 26), 186; Kläger Roland. 'Fair and Equitable Treatment' in International Investment Law, Cambridge Studies in International and Comparative Law, (2011 CUP); Zivković Velimir, '*Fair and Equitable Treatment and the Rule of Law*', (; Edward Elgar Publishing Limited 2023.)

[62] Jean-Étienne-Marie Portalis, Extrait du « Discours préliminaire sur le projet de Code civil » (1801), in *Le discours et le Code. Portalis, deux siècles après le Code Napoléon*, (Litec 2004) 22 ; M. Schwarzschild, 'Keeping it Private' (2007) 44 San Diego Law Review 677, 686.

[63] WTO, Principles of the trading system <https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm> accessed 18 January 2024; Magdalena Pfeiffer, 'Legal certainty and predictability in international succession law', (2016) 12(3) *Journal of Private International Law*, 566.

[64] See, *inter alia*, Fatouros (n 33); Hallward-Driemeier (n 33).

[65] Arjan Lejour and Maria Salfi, 'The Regional Impact of Bilateral Investment Treaties on Foreign Direct Investment', CPB Discussion Paper | 298 <https://www.cpb.nl/sites/default/files/publicaties/download/cpb-discussion-paper-298-regional-impact-bilateral-investment-treaties-foreign-direct-investment.pdf> accessed 11 September 2023.

[66] International Investment Agreements Navigator, China <https://investmentpolicy.unctad.org/international-investment-agreements/countries/42/china> accessed 22 October 2023.

[67] 'Investment flows to developing countries in Asia remained flat in 2022' (*UNCTAD*, 5 July 2023) <https://unctad.org/news/investment-flows-developing-countries-asia-remained-flat-2022> accessed 22 October 2023.

[68] International Investment Agreements Navigator, Japan <https://investmentpolicy.unctad.org/international-investment-agreements/countries/105/japan> accessed 22 October 2023.

[69] Sara Bernow, Bryce Klempner, Clarisse Magnin, 'From 'why' to 'why not': Sustainable investing as the new normal' (October 2017), *Private Equity & Principal Investors Practice October 2017*, McKindsey&Company, 2 <https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/From%20why%20to%20why%20not%20Sustainable%20investing%20as%20the%20new%20normal/From-why-to-why-not-Sustainable-investing-as-the-new-normal.ashx> accessed 24 September 2023.

[70] Yu-Yun Wang, 'Chapter 8 Sustainable Economic Development' in Manuel Guitián, Robert A. Mundell, *Inflation and Growth in China* (1996) International Monetary Fund, 124 <https://www.elibrary.imf.org/display/book/9781557755421/ch010.xml> accessed 22 October 2023.

foreign investment in the short term[71], but prove to be counterproductive and harm the long-term development of a country's economy.[72]

V. Considerations on substantive reforms towards a sustainable ISDS

As argued by South Africa in its submission, the meaning of development is narrowly adopted as "economic growth through the free market, individual property and free flow of capital".[73] However, given the above discussion, public interest *should* be taken into consideration. For this purpose, the complicated reform directed to substantive clauses in ISDS (A) should be backed by a solid framework (B).

A. Substantive reforms

It should be borne in mind that substantive changes in IIAs directed by the sustainable development principles have been pioneered by some countries.[74] These first dispersing substantive reforms clarify the right to regulate and insist on the encouragement of sustainable development protection. Notably, they deal principally with the "labour aspects"[75], environmental protections[76], and corporate social responsibility.[77] It can also be suggested that States could extend their negotiation to human rights protection, such as "reducing poverty and hunger, empowerment of indigenous peoples, promoting decent work, and reversing environmental degradation and climate change".[78]

Some governments take an even further step with the carve-out clauses in IIAs. They started to appear in IIAs in the 1960s, but catered exclusively to tax-related regulation.[79] There are two types of carve-out clauses: carve-out from (specific) obligations under the IIA, and carve out from ISDS. [80] In the first situation, a State party excludes the violation of certain obligations in some specific regulatory areas, while in the second scenario, a State refuses to respond to an ISA claim when it comes to some specific areas listed in the clause. The rationale behind this clause is the exercise of the State's sovereignty. Effectively, by concluding a treaty, a State "restricts its freedom of action or competence".[81] Since the entry into force of an IIA allowing the investor to

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[71] Alan A. Bevan, Saul Estrin, 'The determinants of foreign direct investment into European transition economies' (2004) 32(4) *Journal of Comparative Economics*, 777 <https://doi.org/10.1016/j.jce.2004.08.006> accessed 22 October 2023; Farhad Noorbakhsh, Alberto Paloni and Ali Youssef, 'Low wages or skilled labour? Prospects for foreign direct investment in developing countries' (August 1999) University of Glasgow, pp. 6, 27 <https://www.gla.ac.uk/media/Media_219080_smxx.pdf> accessed 22 October 2023; Stephen S. Golub, Céline Kauffmann, Philip Yeres, 'Defining and measuring green FDI' (2011) OECD Working paper 2011/102, p. 14 <https://www.oecd.org/daf/inv/internationalinvestmentagreements/WP-2011_2.pdf> accessed 22 October 2023.

[72] Michael Gestrin, 'Chapter 2: Investment Promotion and Facilitation' in OECD, *Policy framework for investment: a review of good practices, ISBN 92-64-02586-3*, OECD 2006, p. 41 <https://www.oecd.org/daf/inv/investment-policy/40287315.pdf> accessed 22 October 2023.

[73] South Africa, A/CN.9/WG.III/WP.176 (n 46), para. 5.

[74] See, *inter alia*, 2019 EU–Singapore FTA (Chapter 12), 2020 EU–Vietnam FTA (Chapter 13), 2019 Netherlands Model BIT (esp. preamble and Section 3). Older BITs do not have sustainable development provision: 2004 US Model BIT.

[75] 2019 EU–Singapore FTA (Chapter 12, Section B).

[76] 2019 EU–Singapore FTA (Chapter 12, Section C); 2020 EU–Vietnam FTA (Chapter 13).

[77] 2019 Netherlands Model BIT, Article 7.

[78] South Africa, A/CN.9/WG.III/WP.176 (n 46), para. 16.

[79] Matthew Davie, 'Taxation-Based Investment Treaty Claims' (2015) 6(1) Journal of International Dispute Settlement, pp. 202.

[80] Joshua Paine, Elizabeth Sheargold, 'A Climate Change Carve-Out for Investment Treaties' (2023) 26(2) *Journal of International Economic Law*, 292 .

[81] Articles 27, 46 Vienna Convention on the Law of Treaties (1969); Hans Kelsen, 'Sovereignty and International Law' (1960), Vol. 48, *Georgetown Law Journal*, p. 637.

sue the host State raises the concern of the effectiveness of the State's regulatory power, the simple solution would be allowing that State to carve out some regulatory areas from their commitment to ISDS.[82] Inspired by the carve-out for tax-related regulation, some authors suggests an extension of carve-out clauses to environmental matters,[83] human rights,[84] or public health.[85]

Another potential substantive reform consists of replacing ambiguous terms with more concise standards. ISDS arbitral awards are usually criticised for being inconsistent. The problem may not solely come from the interpretation by arbitrators, but also the broad and ambiguous wording of the clause itself. As pointed out by Mitchell and Sheargold, the general terms such as "necessary", "proportionate" or "related" "to achieving a specific objective" are necessarily subject to interpretation by the arbitral tribunal.[86]

B. Framework for substantive reforms

It can be seen from the above discussion that the wording of the clause itself plays an important role. Therefore, it is desirable that relevant organs, such as the International Law Commission, UNCITRAL, or ICSID, develop model IIAs with commentary to clarify the *raison d'être* of each clause.

This does not however serve to deprive arbitrators of their role of interpreting the law. On the one hand, these documents constitute "subsidiary means for the determination of rules of law"[87] and do not generate international obligations binding on States. On the other hand, as Portalis once put "*Tout prévoir, est un but qu'il est impossible d'atteindre*" (foreseeing all, is a goal impossible to attain)[88], the model clauses are clearly not sufficient. It is necessary to analyse how national and international, pre-established and *ad hoc*, courts and tribunals interpret the clause or similar clauses in different situations.

Regarding interpretation, it is of customary international law codified in Article 31 (3) (c)

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[82] Taejoon Ahn, 'The Utility of Carve-Out Clauses in Addressing Regulatory Concerns in Investment Treaty Arbitration' (2016) 12(1) Asian International Arbitration Journal, (Singapore International Arbitration Centre (in co-operation with Kluwer Law International)), 73.

[83] Joshua Paine, Elizabeth Sheargold (2023) (n 80); Gus Van Harten, 'An ISDS Carve-Out to Support Action on Climate Change' (20 September 2015), Osgoode Legal Studies Research Paper No. 38/2015 <http://dx.doi.org/10.2139/ssrn.2663504> accessed 22 October 2023.

[84] Hélionor de Anzizu, Wafa Ben Mahmoud, Laurence Dubin, and Théophile Keïta, 'Open call for input for Working Group on Business and Human Rights' report on "Human Rights-compatible International Investment Agreements (IIAs)"' (31 March 2021), p. 12 <https://www.ohchr.org/sites/default/files/Documents/Issues/Business/WG/Submissions/CSOs/20210331-Open-call-for-input_WGonBHR_IIAs_H_de-Anzizu.pdf> accessed 22 October 2023, citing Association of Southeast Asian Nations (ASEAN)–India Investment Agreement (2014), Article 3 (5), Austria–Kyrgyzstan BIT (2016), Article 7 (4).

[85] Article 29.5 of Trans-Pacific Partnership Agreement (TPP) specifies that "A Party may elect to deny the benefits of Section B of Chapter 9 (Investment) with respect to claims challenging a tobacco control measure 13 of the Party. Such a claim shall not be submitted to arbitration under Section B of Chapter 9 (Investment) if a Party has made such an election. If a Party has not elected to deny benefits with respect to such claims by the time of the submission of such a claim to arbitration under Section B of Chapter 9 (Investment), a Party may elect to deny benefits during the proceedings. For greater certainty, if a Party elects to deny benefits with respect to such claims, any such claim shall be dismissed."

[86] Andrew Mitchell, Elizabeth Sheargold, 'Protecting the Autonomy of States to Enact Tobacco Control Measures under Trade and Investment Agreements' (2014) 24(e2) Tobacco Control, e148, <http://tobaccocontrol.bmj.com/content/early/2014/10/31/tobaccocontrol-2014-051853.short?rss=1> accessed 22 October 2023.

[87] Article 38 (1) (d) ICJ Statute.

[88] Jean-Étienne-Marie Portalis, Extrait du « Discours préliminaire sur le projet de Code civil » (1801), in *Le discours et le Code. Portalis, deux siècles après le Code Napoléon*, Litec, 2004.

of the 1969 VCLT that a treaty should be interpreted in consistency with "any relevant rules of international law applicable in the relations between the parties". This principle of systemic integration is expected to re-establish the "balance between the interests of investors and those of host States".[89] For this purpose, some remarks are needed. Firstly, the "rules" relevant for the interpretation of the treaties can be either binding or not. While many authors believe that "only binding international rules generating obligations should be considered to interpret a treaty"[90] the practice proves that non-binding rules may play a role.[91] Therefore, for the sake of having a rule useful to the interpretation of the IIA, it is desirable that States adopt binding rules relating to sustainable development, and do not find arguments or try to dismiss the rules' enforceability.[92] Secondly, "relevant" is another term open to interpretation. It must be admitted that the threshold for the relevance varies from author to author.[93] Therefore, it is necessary to draft any international documents in a clear way and avoid ambiguous terms.

VI. Conclusion

ISDS is going through its worst times. The crisis is explained by the unequal mindset establishing the mechanism itself. Paradoxically, ISDS is also the only solution to solve the investment disputes in a peaceful and depoliticised way. The supposed efficiency of the mechanism is proven by the ISDS's best times. In other words, neither a *tabula rasa*, nor an abandonment of the ISDS could be envisaged.

However, this does not mean that one should accept the problems of such a mechanism. The WGIII took the first ambitious step of reforming ISDS procedurally. The procedural reform is expected to precede a "more complicated process" of substantive reform, because even with a permanent investment court and a system of jurisprudence, the lack of coherent and clear provisions prevents the arbitrators from guaranteeing a satisfying balance between private and public interests. Furthermore, such a substantive reform, contrary to common misunderstandings, may be desirable from the perspective of the host State, but also of the foreign investors.

For the substantive reform to be effective, it is desirable that States incorporate responsible and long-term considerations on human right, environmental, and other social matters, in every agreement concluded. Additionally, some States should also conclude a carve-out clause preventing the investors from initiating an ISDS proceeding when it comes to an exhaustive list of issues. Furthermore, clear provisions and guides on how these provisions may be interpreted are expected to contribute to the success of the substantive reform.

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[89] (n 22)

[90] Dörr Oliver, 'Article 31', para. 100 in Dörr Oliver, & Kirsten Schmalenbach (Eds.), *Vienna convention on the law of treaties: a commentary (Second)* (2018 Springer) <https://doi.org/10.1007/978-3-662-55160-8>; Campbell McLachlan, 'The Principle of Systemic Integration and Article 31(3)(c) of the Vienna Convention' (2005) 54(2) ICLQ, 290 <https://doi.org/10.1093/iclq/lei001> accessed 22 October 2023; Giovanna E. Gismondi, 'Chapter 4: The Principle of Systemic Integration in International Investment Law' in *International Environmental Law and International Human Rights Law in Investment Treaty Arbitration: The Contribution of Host States' Argumentation in Re-Shaping International Investment Law*, International Arbitration Law Library, Volume 68 (2023 Kluwer Law International), p. 169.

[91] Dörr (2005) (n 90), para. 100.

[92] The Paris Agreement is an international law treaty (see https://www.un.org/en/climatechange/paris-agreement). However, some authors qualify it as a 'diplomatic agreement'. See, *inter alia*, Kathryn Tso, 'How are countries held accountable under the Paris Agreement?' (*Ask MIT Climate*, 8 March 2021) <https://climate.mit.edu/ask-mit/how-are-countries-held-accountable-under-paris-agreement> accessed 6 October 2023.

[93] Giovanna E. Gismondi (2023) (n 90), 170.